February
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Reducing the Federal Deficit: Strategies and Options

A Report to the Senate and House Committees on the Budget —Part III

As Required by Public Law 93-344

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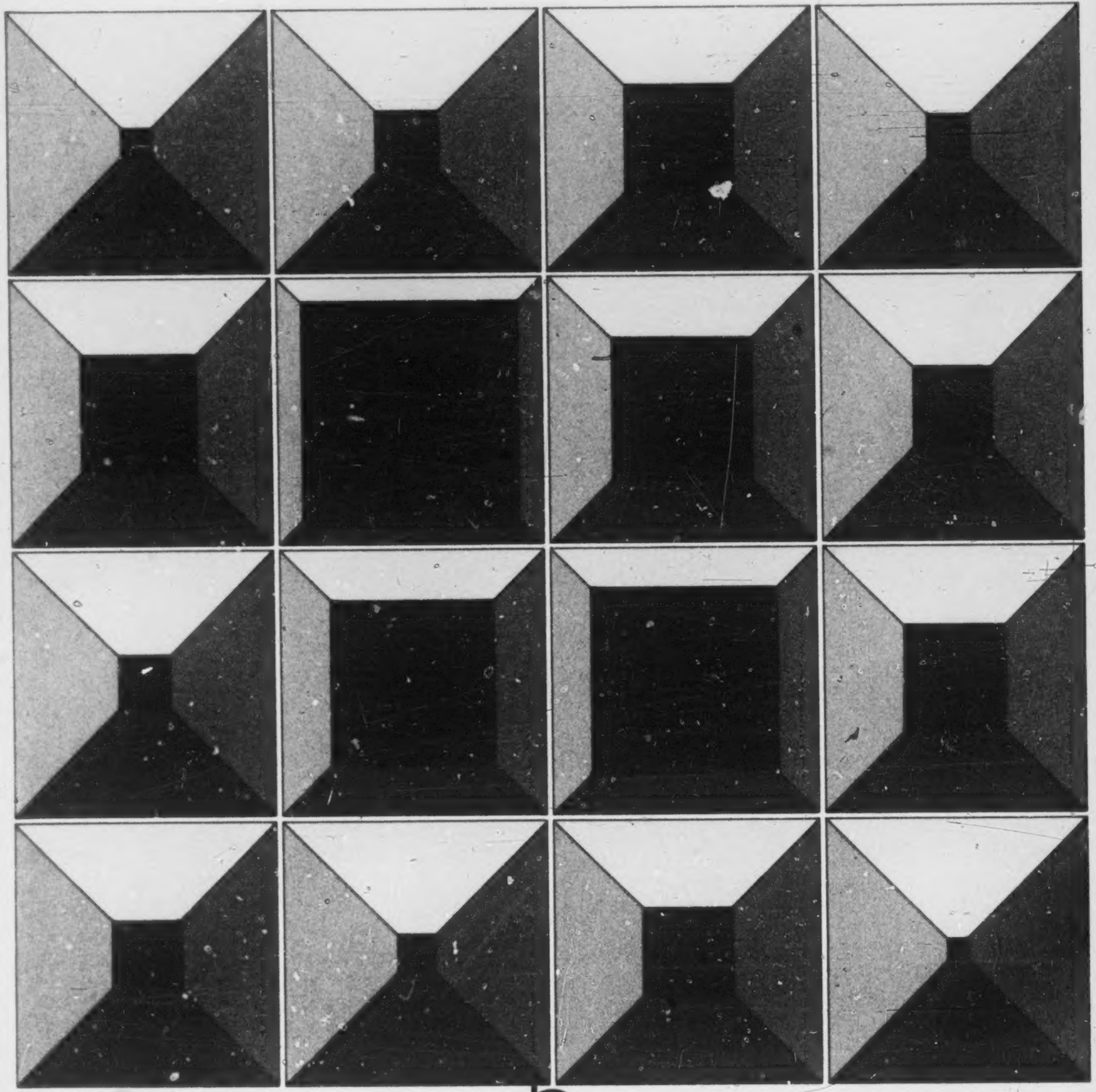

CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

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REDUCING THE FEDERAL DEFICIT:
STRATEGIES AND OPTIONS

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NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years. Likewise, unless otherwise noted, all dollar amounts are expressed in current dollars.

Details in the text and tables of this report may not add to totals because of rounding.

The Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35) is referred to frequently in the text as the 1981 reconciliation act. Similarly, the Economic Recovery Tax Act (ERTA) of 1981 (Public Law 97-34) is occasionally referred to as the 1981 tax act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the House and Senate Committees on the Budget. This year, the report is in three parts, with this report constituting Part III. Part I is entitled The Prospects for Economic Recovery; Part II is Baseline Budget Projections for Fiscal Years 1983-1987. As background information for the Congressional debate on the fiscal year 1983 budget, this report discusses alternative broad strategies for reducing the federal deficit and analyzes various specific options for cutting budget outlays and raising revenues over the 1983-1987 period. The inclusion of an option in this report, or its omission, does not imply a recommendation by CBO. In accordance with CBO's mandate to provide objective and impartial analysis, this report contains no recommendations.

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Alice M. Rivlin
Director

February 1982

CONTENTS

		Page
PREFACE		iii
CHAPTER I.	INTRODUCTION	1
	Plan of the Report	1
CHAPTER II.	BASELINE PROJECTIONS AND BUDGET STRATEGIES	3
	The CBO Baseline Projections	3
	Outlays	3
	Revenues	6
	Deficits	6
	Budget Strategies	6
	Outlay Strategies	10
	Revenue Strategies	15
	Realigning Federal, State, and Local Responsibilities	15
	Economic and Other Considerations	19
	Economic Impacts	19
	Budget Offsets	20
	Cumulative Effects	20
	Timing Considerations	21
CHAPTER III.	NATIONAL DEFENSE	23
	Budget History and Projections	23
	Historical Trends, 1970-1981	23
	The 1982 Budget Decisions	25
	Baseline Projections, 1983-1987	27
	Budget Strategies: Priorities in Defense	29
	Altering the Composition of the Strategic Nuclear Force Buildup	30
	Shifting Program Emphasis to Improve U.S. Projection Forces	36
	Seeking Alternative Approaches to Accomplish Existing Missions	41
	Changing Pay, Support, and Acquisition Policies	48
	Concluding Comments	54

CONTENTS (continued)

Page

CHAPTER IV. INTERNATIONAL AFFAIRS 57

Budget History and Projections 57
Historical Trends, 1970-1981 57
The 1982 Budget Decisions 59
Baseline Projections, 1983-1987 60
Budget Strategies 60
Reducing U.S. Export Promotion Efforts . . . 60
Reassessing Individual Foreign Aid Programs in Terms of Current Policy Objectives and Economic Conditions 64
Concluding Comments 68

CHAPTER V. NATURAL RESOURCES, ENERGY, AND SCIENCE 71

Budget History and Projections 71
Historical Trends, 1970-1981 72
The 1982 Budget Decisions 74
Baseline Projections, 1983-1987 75
Budget Strategies 76
Concentrating on Basic Research and Reducing Commercialization Efforts 76
Changing the Federal/State Division of Responsibilities and Revenues 80
Recovering Costs of Government Services. . . 82
Obtaining Market Value for Federal Resources 85
Concluding Comments 86

CHAPTER VI. AGRICULTURE 89

Budget History and Projections 89
Historical Trends, 1970-1981 89
The 1982 Budget Decisions 92
Baseline Projections, 1983-1987 93
Budget Strategies 93
Increasing Reliance on Markets in Determining Farm Prices and Incomes . . . 94
Shifting Some Expenditures to States or Local Governments or to Private Groups 98
Concluding Comments 100

CONTENTS (continued)

Page

CHAPTER VII. TRANSPORTATION, COMMERCE AND HOUSING CREDIT, AND COMMUNITY AND REGIONAL DEVELOPMENT 101

Budget History and Projections 101
  Historical Trends, 1970-1981 102
  The 1982 Budget Decisions 105
  Baseline Projections, 1983-1987. 107
Budget Strategies 108
  Increasing User Fees 108
  Shifting Responsibility to State and Local Governments 112
  Targeting Funds to the Neediest Areas and Populations 114
  Reducing Subsidies for Private Sector Activities 115
Concluding Comments 118

CHAPTER VIII. EDUCATION, EMPLOYMENT AND TRAINING, SOCIAL SERVICES, AND GENERAL REVENUE SHARING 121

Budget History and Projections 122
  Historical Trends, 1970-1981 122
  The 1982 Budget Decisions 125
  Baseline Projections, 1983-1987 126
Budget Strategies 126
  Increasing Targeting 127
  Reducing the Federal Role in Selected Areas 130
Concluding Comments 132

CHAPTER IX. HEALTH 133

Budget History and Projections 133
  Historical Trends, 1970-1981 134
  The 1982 Budget Decisions 137
  Baseline Projections, 1983-1987. 138

CONTENTS (continued)

Page

Budget Strategies 139
  Shifting Responsibility to Beneficiaries 140
  Shifting Responsibility to Medical Providers 143
  Shifting Responsibility to Other Levels of Government 144
  Shifting Responsibility to Taxpayers 145
Concluding Comments 146

CHAPTER X. INCOME SECURITY 149

Budget History and Projections 149
  Historical Trends, 1970-1981. 150
  The 1982 Budget Decisions 153
  Baseline Projections, 1983-1987 154
Budget Strategies 155
  Changes in Social Security 157
  Changes in Veterans' Programs 163
  Changes in Other Income Security Programs . . 166
Concluding Comments 168

CHAPTER XI. COMPENSATION FOR THE FEDERAL CIVILIAN WORKFORCE 169

Budget History and Projections 169
  Historical Trends, 1970-1981. 169
  The 1982 Budget Decisions 174
  Baseline Projections, 1983-1987 175
Budget Strategies 176
  Reducing CSR Benefits 177
  Increasing CSR Contributions 181
  Total Compensation 182
Concluding Comments 183

CONTENTS (continued)

Page

CHAPTER XII. TAX REVENUES 185

Budget History and Projections 185
  Historical Trends, 1970-1981. 186
  The Economic Recovery Tax Act of 1981 187
  Baseline Projections, 1983-1987 189
Budget Strategies 190
  Scaling Back the 1981 Tax Cut 191
  Reducing Tax Expenditures, Obsolete Incentives, and Tax Avoidance 194
  Introducing New or Increased Taxes 197
  More Fundamental Changes 205
Concluding Comments 207

CHAPTER XIII. THE CREDIT BUDGET-- LOANS AND LOAN GUARANTEES 209

Budget History and Projections 210
  Historical Trends, 1970-1980 210
  The 1982 Budget Decisions 212
Budget Strategies 212
  Terminating Federal Programs That Duplicate Private Sector Lending 213
  Eliminating or Reducing Interest Subsidies 215
  Revising Eligibility Criteria and Loan Terms 216
Promoting Sound Budgeting Practices 217
Concluding Comments 218

TABLES

Page

TABLE II-1. BASELINE ECONOMIC ASSUMPTIONS 4

TABLE II-2. BASELINE OUTLAY PROJECTIONS FOR MAJOR PROGRAM CATEGORIES 5

TABLE II-3. BASELINE REVENUE PROJECTIONS BY SOURCE 7

TABLE II-4. BASELINE BUDGET PROJECTIONS 8

TABLE III-1. BUDGET AUTHORITY AND OUTLAYS FOR NATIONAL DEFENSE 24

TABLE III-2. U.S. DEFENSE FORCES 26

TABLE III-3. POTENTIAL SAVINGS RELATIVE TO POSSIBLE ADMINISTRATION PROGRAM, FISCAL YEARS 1983-1987 32

TABLE IV-1. FEDERAL OUTLAYS FOR INTERNATIONAL AFFAIRS. . 58

TABLE V-1. FEDERAL OUTLAYS FOR NATURAL RESOURCES, ENERGY, AND SCIENCE 73

TABLE VI-1. FEDERAL OUTLAYS FOR AGRICULTURE 90

TABLE VII-1. FEDERAL OUTLAYS FOR TRANSPORTATION, COMMERCE AND HOUSING CREDIT, AND COMMUNITY AND REGIONAL DEVELOPMENT 103

TABLE VIII-1. FEDERAL OUTLAYS FOR EDUCATION, EMPLOYMENT AND TRAINING, SOCIAL SERVICES, AND GENERAL PURPOSE FISCAL ASSISTANCE . . . 123

TABLE IX-1. FEDERAL OUTLAYS FOR HEALTH 134

TABLE X-1. FEDERAL OUTLAYS FOR INCOME SECURITY PROGRAMS 150

TABLES

Page

TABLE XI-1. FEDERAL COMPENSATION OUTLAYS FOR CIVILIAN PAY AND RETIREMENT 170

TABLE XI-2. ESTIMATED DISTRIBUTION OF FEDERAL CIVILIAN WORKFORCE BY GOVERNMENTAL ACTIVITY 172

TABLE XII-1. BUDGET REVENUES BY SOURCE, SELECTED FISCAL YEARS, 1960 TO 1987 188

TABLE XII-2. REVENUE INCREASES FROM SCALING BACK THE INDIVIDUAL INCOME TAX CUTS IN THE ECONOMIC RECOVERY TAX ACT OF 1981 192

TABLE XII-3. REVENUE EFFECTS OF 1981 INCOME TAX RATE CUTS COMPARED WITH INFLATION-INDUCED INCOME TAX INCREASES 193

TABLE XII-4. REVENUE GAINS FROM POSSIBLE REDUCTIONS IN TAX EXPENDITURES, FISCAL YEARS 1983 AND 1987 195

TABLE XII-5. GROSS REVENUE INCREASES FROM DOUBLING EXISTING EXCISE TAXES 201

TABLE XII-6. POTENTIAL REVENUE INCREASES FROM SELECTED USER FEES, FISCAL YEARS 1983 AND 1987 204

FIGURES

Page

FIGURE III-1. BUDGET AUTHORITY FOR NATIONAL DEFENSE, 1955-1982 24

FIGURE XII-1. FEDERAL REVENUES AS A PERCENTAGE OF GNP, 1960 TO 1987 186

APPENDIX A. BUDGET REDUCTION OPTIONS

Page

National Security (Function 050)

A-050-a Eliminate Dual Pay for Reservists Who Are Federal Employees A-3
A-050-b Phase In Over the Next Three Years the "High-3" Retirement Benefit Calculation for All Military Personnel A-4
A-050-c Reduce Cost-of-Living Allowances for Working-Age Military Retirees A-5

International Affairs (Function 150)

A-150-a Increase Interest Charges on Bilateral Loans A-6
A-150-b End Public Law 480 Title I Sales A-8
A-150-c Charge Market Interest Rates on Export-Import Bank Direct Loans A-10

Energy (Function 270)

A-270-a Terminate the Solvent Refined Coal-I (SRC-I) Demonstration Plant A-12
A-270-b Terminate the Clinch River Breeder Reactor . . A-14
A-270-c Finance Nuclear Waste Programs with Surcharge on Nuclear Power Generation A-15
A-270-d Price Uranium Enrichment at Fair-Market Value A-16
A-270-e Cut Subsidies for Synthetic Fuels A-18
A-270-f Reduce REA Interest Subsidies and Target REA Lending More Efficiently A-20

Natural Resources and Environment (Function 300)

A-300-a Increase Price of Bureau of Reclamation Irrigation Water A-23
A-300-b Allocate Federal Grazing Rights at Market Rates A-24

APPENDIX A (Continued)

Page

A-300-c Change Federal-State Share of Mineral Receipts A-26
A-300-d Increase Entry Charges for Outdoor Recreation Areas A-27
A-300-e Reduce Funding for EPA Construction Grants . . A-28

Agriculture (Function 350)

A-350-a Eliminate FmHA Farm Loan Interest Subsidies . . A-30
A-350-b Reduce the Level of Dairy Price Support . . . A-32
A-350-c Eliminate Farm Deficiency Payments A-34
A-350-d Phase Out Tobacco and Peanut Price Support Programs A-36
A-350-e Eliminate Wool and Mohair Payment Program . . . A-38
A-350-f Reduce Extension Education Aid to State and Local Governments A-39
A-350-g Terminate Federal Funding of Foreign Market Development A-40

Commerce and Housing Credit (Function 370)

A-370-a Increase the Share of Income That Tenants of Rural Housing Projects Pay Toward Their Rent A-41
A-370-b Discontinue Direct Postal Service Subsidies . . A-42
A-370-c Eliminate Small Business Administration Business Loans and Programs A-44

Transportation (Function 400)

A-400-a Reduce Funding for Amtrak A-46
A-400-b End Mass Transit Operating Subsidies A-48
A-400-c Reduce Federal Share for Mass Transit Capital Grants A-50
A-400-d Refocus the Federal Highway Program A-52
A-400-e Shift Airways Operating Costs to the Airport and Airways Trust Fund A-54
A-400-f End Grants-in-Aid for Large Airports A-55

APPENDIX A (Continued)

Page

A-400-g Eliminate Maritime Industry Subsidies A-57

Community and Regional Development (Function 450)

A-450-a Reduce Funding for the Community Development Block Grant Program A-59
A-450-b Reduce Funding for Local Economic Development A-61

Education, Training, Employment, and Social Services (Function 500)

A-500-a Reduce Funding for Elementary and Secondary Education Block Grant A-63
A-500-b Reduce Funding for Vocational Education A-64
A-500-c Restructure Campus-Based Student Aid Programs and Reduce Their Funding A-66
A-500-d Eliminate Federal In-School Interest Payments for Graduate Students A-67
A-500-e Require States to Put Up Matching Funds for CETA Training Programs A-69

Health (Function 550)

A-550-a Cap Medicaid Expenditures for Long-Term Care . A-70
A-550-b Alter the Pattern of Hospital Coinsurance Charges Under Medicare A-72
A-550-c Expand Medicare Hospital Reimbursement Limits to Include Ancillary Services A-74
A-550-d Provide Incentives to States for Hospital Cost Containment A-76
A-550-e Reduce Federal Support for Biomedical Research A-78

Income Security (Function 600)

A-600-a Lengthen the Social Security AIME Computation Period by Three Years A-79

APPENDIX A (Continued)

Page

A-600-b Delay the Social Security Cost-of-Living Adjustment by Three Months A-81
A-600-c Reduce Automatic Social Security COLA to Two-Thirds of the CPI Increase, but Institute a Discretionary Supplement A-82
A-600-d Limit Retirement Cost-of-Living Adjustments to Correct for Past Overindexation A-84
A-600-e Eliminate Mother's and Father's Social Security Benefits When Youngest Child Attains Age 6 . . . . A-87
A-600-f Index "Bend Points" in the Social Security Benefit Computation Formula by Only 50 Percent of Wage Increases over Five Years A-89
A-600-g Retain Earnings Test for Social Security Beneficiaries Aged 70 and 71 . . . . A-91
A-600-h Eliminate Social Security Benefits for Children of Retirees Aged 62-64 . . . . A-92
A-600-i Limit Combined Federal Disability Benefits . . A-94
A-600-j Change Civil Service Retirement Cost-of-Living Adjustments A-96
A-600-k Reform Federal Workers' Compensation Program . A-98
A-600-l Modify Certain Civil Service Retirement Benefit Provisions A-99
A-600-m Conform Certain Civil Service Retirement Provisions to Recent Social Security Adjustments A-101
A-600-n Change Procedure for Determining Subsidy Payments in the Section 8 Housing Assistance Program A-103
A-600-o Fund Child Nutrition Programs with a Block Grant A-105
A-600-p Include Minor Siblings in the AFDC Assistance Unit for Computing Benefits A-107

APPENDIX A (Continued)

Page

Veterans' Benefits and Services (Function 700)

A-700-a End VA Compensation to Veterans with 10 Percent or Less Disability A-109
A-700-b Close Certain VA Hospitals A-110

General Government (Function 800)

A-800-a Discontinue Donation of Surplus Federal Property A-112

General Purpose Fiscal Assistance (Function 850)

A-850-a End General Revenue Sharing Funding for Jurisdictions with Strong Fiscal Condition A-114

Undistributed Offsetting Receipts (Function 950)

A-950-a Charge the Postal Service for Certain Retirement Costs A-115

All Budget Functions

A-ALL-a Accelerate Reclassification of Federal White-Collar Jobs A-117
A-ALL-b Strengthen Agency Debt Collection A-118

APPENDIX B. OPTIONS TO INCREASE TAX REVENUES

Page

International Affairs (Function 150)

B-150-a Phase Out Domestic International Sales Corporations B-2

Energy (Function 270)

B-270-a Modify Tax Treatment of Foreign Oil and Gas Income B-4
B-270-b Repeal Percentage Depletion Allowance for Oil and Gas B-6
B-270-c Repeal Expensing of Intangible Oil and Gas Drilling Costs B-8
B-270-d Repeal Residential Energy Tax Credits B-10
B-270-e Eliminate the Excise Tax Exemption for Alcohol Fuels B-12
B-270-f Finance the Strategic Petroleum Reserve with a Petroleum Tax B-13

Natural Resources and Environment (Function 300)

B-300-a Eliminate Capital Gains Treatment of Timber. . B-14
B-300-b Eliminate Tax-Exemption for Pollution Control Bonds B-15
B-300-c Increase Waterway User Charges B-16
B-300-d Levy User Charges for Deep-Draft Navigation Expenses B-18

Commerce and Housing Credit (Function 370)

B-370-a Limit Home Mortgage Interest Deduction To $5,000 . . . . B-19
B-370-b Tax 10 Percent of the Capital Gains on Home Sales B-21
B-370-c Terminate Deductibility of Consumer Interest Payments B-23
B-370-d Eliminate Tax Exemption for Small Issue Industrial Revenue Bonds B-24

APPENDIX B (Continued)

Page

B-370-e Limit Business Meal and Entertainment Deductions to 80 Percent of Amount Spent B-26

Transportation (Function 400)

B-400-a Increase Aviation User Fees B-28
B-400-b Levy User Charges for Certain Coast Guard Activities B-29

Community and Regional Development (Function 450)

B-450-a Eliminate Tax Credits for Rehabilitating Older Buildings B-31

Education, Training, Employment, and Social Services (Function 500)

B-500-a Repeal Extra Parental Personal Exemption for Students B-33
B-500-b Tax Scholarship and Fellowship Income B-34
B-500-c Tax Fringe Benefits B-36

Health (Function 550)

B-550-a Tighten the Medical Expense Deduction B-38
B-550-b Tax Some Employer-Paid Health Insurance . . . B-40
B-550-c Eliminate Tax-Exemption for Private Hospital Bonds B-42
B-550-d Increase Medicare Part B Premiums B-43
B-550-e Impose a Premium Tax on Private Insurance that Supplements Medicare B-44

Income Security (Function 600)

B-600-a Repeal the Casualty Loss Deduction B-46
B-600-b Eliminate Extra Tax Exemption for the Elderly and Blind B-48

Page

B-600-c Tax Half of Retirement Benefits for Social Security Recipients with Incomes Above $20,000/$25,000 . . . . . . B-49
B-600-d Cover New Government Employees Under Social Security B-51
B-600-e Tax Workers' Compensation Benefits B-53
B-600-f Tax Railroad Retirement Benefits B-54
B-600-g Tax Accrued Interest on Life Insurance Reserves B-56
B-600-h Raise Civil Service Retirement Contribution Rates B-58
B-600-i Tax All Unemployment Insurance Benefits . . . B-60
B-600-j Tax Federal Employees for Medicare B-62

Veterans' Benefits and Services (Function 700)

B-700-a Tax Veterans' Disability Compensation B-64

General Purpose Fiscal Assistance (Function 850)

B-850-a Eliminate Deductibility of State and Local Sales Taxes B-66
B-850-b Limit Tax Credit for Possessions Corporations B-68

APPENDIX C. ASSUMPTIONS USED IN NATIONAL DEFENSE PROJECTIONS--QUANTITIES OF WEAPONS PROCURED UNDER CBO BASELINE, POSSIBLE ADMINISTRATION PROGRAM, AND ALTERNATIVE

		Page
TABLE C-1.	Quantities Procured Under "Leapfrog the B-1 Bomber and Proceed Directly to an Advanced Technology Bomber While Increasing B-52 Alert Rates"	C-3
TABLE C-2.	Quantities Procured Under "Modify the Tanker Re-Engining Program"	C-3
TABLE C-3.	Quantities Procured Under "Modify and Expand Navy Battle Group Structure"	C-4
TABLE C-4.	Quantities Procured Under "Restructure the Modernization of Naval Air Defenses" . .	C-4
TABLE C-5.	Quantities Procured Under "Procure Conventional Submarines to Complement Nuclear Attack Submarines"	C-5
TABLE C-6.	Quantities Procured Under "Limit M1 Tank Procurement and Supplement it With M60s"	C-5
TABLE C-7.	Quantities Procured Under "Alter the Composition of the Infantry Fighting Vehicle Program"	C-6
TABLE C-8.	Quantities Procured Under "Revise the Navy Aircraft Modernization Program"	C-6

CHAPTER I. INTRODUCTION

The federal deficit in fiscal year 1981 was about $58 billion. The Congressional Budget Office (CBO) estimates that, if current policies were continued unchanged, this total would rise to $109 billion in 1982, $188 billion in 1984, and as much as $248 billion in 1987. Such a substantial increase would raise the deficit as a percentage of gross national product (GNP) from 2 percent in 1981 to approximately 5 percent between 1984 and 1987. If this prospective growth in the federal budget deficit were principally a cyclical phenomenon, it would be cause for little concern. Indeed, rising budget deficits during periods of recession help to counteract declines in economic activity. Unfortunately, however, the budget problem facing the Congress is not a cyclical one. Instead, without significant legislative changes in federal spending or taxing policies, large budget deficits will continue indefinitely.

The prospect of growing deficits represents a major departure from previous CBO baseline budget projections, in which revenues grew faster than outlays and the budget began to show a surplus within two or three years. The surplus in those projections was caused by revenues' increasing more rapidly than GNP as inflation and economic growth pushed taxpayers into higher income tax brackets. Outlays, on the other hand, grew more slowly because most spending was assumed merely to keep pace with inflation.

During its second session, the 97th Congress will be debating various proposals to reduce these large deficits. This report discusses alternative strategies for cutting spending; it also analyzes specific options for each of the major program areas in the budget. In addition, the report examines a broad range of alternative tax increases, as well as some options to lower the level of federal credit outstanding.

PLAN OF THE REPORT

Chapter II discusses CBO's baseline budget projections. It sets forth broad strategies that could be used to reduce spending in the areas of defense, benefit payments to individuals, grants-in-aid to state and local governments, and other federal expenditures. Finally, it describes certain issues that should be considered in making budget and tax decisions.

Chapters III through XI detail the broad reduction strategies for each major budget function. Under each strategy, specific options are outlined, together with estimates of potential savings and some of the major programmatic effects. Most of the specific budget options are cross-referenced to Appendix A, where additional budget and program information are given. (Appendix A also presents a number of options that do not fall under any one of the broad strategies outlined in the text chapters.)

Chapter XII discusses options for raising revenues, ranging from postponing some of the income tax reductions now scheduled to introducing new consumption or value-added taxes. It also outlines incremental adjustments to the current tax system, such as eliminating certain tax expenditures. These are treated more fully in Appendix B. Possible new taxes, on items such as natural gas and oil imports, are also briefly discussed in this chapter, along with options for changing excise taxes.

Chapter XIII outlines ways to reduce the amount of federal credit outstanding. Not only do large federal deficits have an impact on financial markets; the fact that the federal government reallocates capital by its loans and loan guarantees also has an impact. For this reason, as well as the fact that credit programs are often viewed as substitutes for spending programs, credit options should be included in a report on reducing the overall federal deficit. Some options would generate outlay reductions, while others would merely lessen the degree of federal intervention in financial markets.

CHAPTER II. BASELINE PROJECTIONS AND BUDGET STRATEGIES

This chapter summarizes the Congressional Budget Office baseline budget projections used to estimate the effects of the budget and tax changes discussed in this report. It also highlights strategies that could be followed to reduce budget deficits over the next five years. (Each of the broad strategies is developed more fully in the subsequent chapters.) Finally, it surveys some of the economic and administrative issues that should be considered in reaching budget and tax decisions.

THE CBO BASELINE PROJECTIONS

The budget projections are intended to provide a baseline from which to measure the effects of tax and budget changes. They indicate the likely course of federal spending and revenues if present policies were continued and if the economy performed according to certain assumptions. The projections are not, therefore, a forecast of actual budget outcomes. The economic assumptions underlying the projections are given in Table II-1. 1/

Outlays

Federal outlays are projected to increase from $740 billion in 1982 to $1.1 trillion in 1987 (see Table II-2). The largest dollar increase is in benefit payments, which include payments for retired and disabled workers and their dependents and survivors, unemployed workers, veterans, students, low-income families and individuals, and also health-care benefits provided under Medicare and Medicaid. Total funding for these payments is projected to rise from $351 billion in 1982 to $533 billion in 1987. National defense accounts

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1. A more detailed presentation of the CBO's baseline projections and underlying economic assumptions is given in the two other volumes of this three-part report to the Senate and House Committees on the Budget. See Congressional Budget Office, Part I, The Prospects for Economic Recovery (February 1982), and Part II, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982).

for the next largest increase, projected to grow from $190 billion in 1982 to $303 billion in 1987. Net interest costs are projected approximately to double, from $85 billion to $168 billion. The remaining two categories of federal spending are projected to increase only slightly, with grants to state and local governments rising from $49 billion to $57 billion, and other federal operations from $64 billion to $69 billion. Altogether, outlays are projected to grow about one percentage point less than the assumed growth in the gross national product. Consequently, as a percentage of GNP, outlays are projected to decline from 24.2 percent in 1982 to 22.7 percent in 1987.

TABLE II-1. BASELINE ECONOMIC ASSUMPTIONS (By calendar year, dollar amounts in billions)

	Actual	Forecast		Longer-Term Assumptions a/			
	1981	1982	1983	1984	1985	1986	1987
Gross National Product (GNP)							
Current dollars							
Amount	2,922	3,140	3,515	3,882	4,259	4,659	5,083
Percent change, year to year	11.3	7.5	11.9	10.4	9.7	9.4	9.1
Constant (1972) dollars							
Amount	1,510	1,509	1,574	1,632	1,689	1,748	1,809
Percent change, year to year	1.9	-0.1 b/	4.4	3.6	3.5	3.5	3.5
Prices							
GNP deflator (percent change, year to year)	9.1	7.5	7.3	6.6	6.0	5.7	5.4
Consumer Price Index (percent change, year to year)	10.3	7.5	6.9	6.9	6.4	6.0	5.7
Unemployment Rate (percent, annual average)	7.6	8.9	8.0	7.4	7.2	6.9	6.7
Interest Rate (91-day Treasury bills, percent, annual average)	14.0	12.0	13.2	11.3	9.4	8.7	8.1

a. The figures for 1982 and 1983 are taken from CBO's economic forecast for those years. The figures for the 1984-1987 period are not forecasts; rather, they are assumptions of moderate noncyclical growth with sustained progress in reducing inflation and unemployment. It is uncertain whether the economic progress assumed in these projections can be attained with the prospective trend of money growth and without the enactment of further spending cuts or tax increases to reduce the deficit.

a. Minus sign denotes a negative growth rate.

TABLE II-2. BASELINE OUTLAY PROJECTIONS FOR MAJOR PROGRAM CATEGORIES (By fiscal year, in billions of dollars)

	Actual 1981	Estimated 1982	Baseline Projection 1983	1984	1985	1986	1987
National Defense a/	160	190	214	238	263	286	303
Benefit Payments for Individuals b/	320	351	383	413	452	490	533
Grants to State and Local Governments c/	55	49	48	49	51	54	57
Net Interest	69	85	106	130	143	156	168
Other Federal Operations	57	64	58	59	62	67	69
Total	661	740	809	889	971	1,052	1,130

NOTE: Details may not add to totals because of rounding.

a. Includes benefit payments for retired military personnel.

b. Some grants to state and local governments go toward such benefit payments as Medicaid and Aid to Families with Dependent Children. These grants are classified here as benefit payments for individuals.

c. This category covers grants for purposes such as general revenue sharing, highway construction, community development, and employment and training assistance. It does not include grants for benefit payments.

Not only do these projections depend upon the underlying economic assumptions; in some cases, they depend on specific assumptions regarding adjustments for inflation. For all non-defense discretionary appropriation accounts, it is assumed that funding levels are maintained in constant terms over the projection period unless they are specifically capped by authorization levels.

For defense, the baseline projections reflect the explicit programs proposed by the Administration, as amended for fiscal year 1982 by Congressional action and adjusted for the outyears by CBO according to its interpretation of Congressional intent. Under these assumptions, defense budget authority rises (in real terms) by about 4.5 percent in 1983, by 2.2 percent in 1984, and declines slightly thereafter. An alternative defense baseline is also discussed in Chapter III, in which budget authority is assumed to increase (in real terms) approximately 6.2 percent in 1983 and 7 percent thereafter. Under this assumption, outlays for defense would be higher than the CBO baseline projection by $1 billion in 1983, by $7 billion in 1984, and by $70 billion in 1987. This would increase total projected outlays to $810 billion in 1983 and $1.2 trillion in 1987.

Revenues

Under current tax laws, revenues are projected to grow by less than 7 percent a year during the next five years, from $631 billion in 1982 to $882 billion in 1987 (see Table II-3). This substantial slowing in the growth of revenues results primarily from the major tax changes embodied in the Economic Recovery Tax Act of 1981. The share of corporate and personal income taxes decreases over the projection period, while the social insurance share of taxes increases.

Deficits

These outlay and revenue projections result in large and growing budget deficits, increasing from $109 billion in 1982 to $188 billion in 1984 and $248 billion in 1987 (see Table II-4). As a percentage of GNP, deficits increase from 2 percent in 1981 to approximately 5 percent in 1985, 1986, and 1987. If a 7 percent annual real growth in budget authority for defense is assumed, the deficit in 1987 increases to $318 billion. Off-budget outlays add another $19 billion to the federal deficit in 1983 and $22 billion in 1987.

BUDGET STRATEGIES

As the above projections show, the size of the federal deficit is projected to be significant in 1983 and to continue growing through 1987. Both the projected magnitude of the deficit and the

TABLE II-3. BASELINE REVENUE PROJECTIONS BY SOURCE (By fiscal year, in billions of dollars)

	Actual	Estimated	Baseline Projection				
	1981	1982	1983	1984	1985	1986	1987
Individual Income Taxes	285.6	300	303	316	344	367	396
Corporate Income Taxes	61.1	50	51	62	63	64	73
Social Insurance Taxes	186.4	209	227	250	282	313	339
Excise Taxes							
Windfall profit taxes	23.3	23	21	21	20	20	20
Other excise taxes	17.5	18	19	20	16	16	16
Estate and Gift Taxes	6.8	7	6	6	5	5	4
Customs Duties	8.1	9	9	9	10	10	10
Miscellaneous Revenues	13.8	15	16	18	19	19	19
Total Current Law Revenues	602.6	631	652	701	759	814	877
Extension of Highway Trust Fund Taxes	---	---	---	---	4	4	4
Total Baseline Revenues	602.6	631	652	701	763	818	882

NOTE: Details may not add to totals because of rounding.

limited flexibility to reduce outlays in the near term demonstrate the severity of the problem facing the Congress.

To achieve lower deficits will require further reductions in the growth of federal spending and/or significant tax increases. For example, to hold the budget deficit at the 1981 level of 2 percent of GNP in 1987 would mean limiting the deficit to approximately $100 billion in that year. To do this would require some combination of spending reductions and tax increases that would total $148 billion in 1987.

If the lower deficits were to be achieved solely through spending reductions, total outlays over the next five years would have to be held to an average growth rate of less than 6 percent per year--about three percentage points below the projected growth

TABLE II-4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	Actual 1981	Estimated 1982	Projections 1983	1984	1985	1986	1987
	(In Billions of Dollars)						
Baseline Revenues	603	631	652	701	763	818	882
Baseline Outlays	660	740	809	889	971	1,052	1,130
Baseline Unified Budget Deficit	58	109	157	188	208	234	248
Outlays of Off-Budget Federal Entities	21	20	19	18	18	20	22
Total Deficit	79	129	176	206	226	254	270
Baseline Budget Authority	716	771	863	948	1,037	1,114	1,191
	(As a Percent of GNP)						
Baseline Revenues	21.1	20.6	19.0	18.5	18.3	18.0	17.7
Baseline Outlays	23.1	24.2	23.6	23.5	23.3	23.1	22.7
Baseline Unified Budget Deficit	2.0	3.6	4.6	5.0	5.0	5.1	5.0
Outlays of Off-Budget Federal Entities	0.7	0.7	0.6	0.5	0.4	0.4	0.4
Total Deficit	2.7	4.2	5.1	5.4	5.4	5.6	5.4

of baseline outlays. If these outlay reductions were concentrated in national defense programs and benefit payments for individuals--which account for three-fourths of the projected increase in baseline outlays--1987 outlays for these purposes would have to be reduced by almost 18 percent below baseline levels. This would mean a $54 billion reduction in national defense outlays from the 1987 baseline level and a $94 billion reduction in benefit payments. It would not permit any real growth in defense outlays between 1982 and 1987, and it would cut the projected growth in benefit payments by half or more.

Reductions in defense spending of this order of magnitude, however, are very difficult to achieve because of the lag that occurs between reductions in appropriations and reductions in outlays. In Social Security and other programs under which benefits are raised automatically for increases in the Consumer Price Index (CPI), substantial short-run savings could be obtained by adjusting the indexing provisions. Such changes would not be sufficient, however, to reduce benefit payments by 18 percent below the projected 1987 baseline levels. To achieve savings of this magnitude, substantial further reductions in real benefit levels would be required.

An alternative approach would be to concentrate the necessary spending reductions on grants to state and local governments (other than for benefit payments) and other federal activities. As shown in Table II-2, however, these two budget categories are relatively small, and together, they are projected to total $127 billion by 1987 under CBO's baseline assumptions. 2/ Consequently, eliminating all such federally assisted activities (which include all natural resources, transportation, community and economic development, and most environmental and scientific programs) would still leave a deficit of well over $100 billion in 1987.

If, on the other hand, the deficit reductions were to be achieved solely on the revenue side, individual income taxes would have to be increased by 37 percent from the projected baseline level in 1987, or some major changes would have to be made in other taxes.

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2. The $127 billion total represents net outlays after subtracting projected receipts for sales of leases on Outer Continental Shelf Lands and other purposes.

Outlay Strategies

A number of broad strategies for reducing projected outlays are outlined on the following pages.

Benefit Payments for Individuals. As stated above, this category of spending--by far the largest--is projected to increase from $351 billion in 1982 to $533 billion in 1987. Much of the recent growth in benefit payments resulted from increases in benefit levels legislated during the early 1970s, automatic indexing of various cash benefits to the CPI, and rapidly rising health-care costs (see Chapters IX, X, and XI for detailed discussion).

Outlay reductions in this category could be achieved by either reducing benefits across the board or targeting the reductions toward those recipients deemed least needy. Across-the-board changes could entail limiting the automatic indexation of benefits, thereby controlling future outlays. One example, which could be implemented quickly, would be a lowering of the cost-of-living adjustment (COLA) for Social Security from 100 percent of the change in the CPI increase to two-thirds, reducing outlays by $26 billion annually by 1987. A targeted change would be to postpone the elimination of the earnings test for Social Security beneficiaries aged 70-71, now scheduled for July 1983, to 1988 or beyond. Annual savings would rise to $690 million in 1987.

Similar choices are available in Medicare. Net benefits could be cut across the board by raising the premium for Part B (physician) coverage or by raising the coinsurance payment for hospital services. By 1987, these two changes would yield annual federal savings of $3.7 billion and $1.9 billion, respectively. Alternatively, the premium or coinsurance increase could be made larger but limited to persons with incomes above a certain threshold.

In veterans' compensation, benefits could be reduced across the board by setting the COLA at less than the full increase in the CPI. Benefits could also be targeted by reducing them for beneficiaries who are less than 30 percent disabled. Since those with lesser disabilities have less impaired earnings abilities, this option would redirect the remaining benefits to those who need them most. Savings in 1987 would amount to $1.6 billion.

Defense. Defense spending is projected to increase from $190 billion in 1982 to $303 billion in 1987 under the CBO baseline assumptions. If budget authority in this area were to continue to increase by about 7 percent annually in real terms over the projection period, outlays could total $373 billion in 1987.

A number of options could reduce the rate of growth in defense spending (see Chapter III for detailed discussion). Although they would also reduce the buildup of defense capability, some strategies could minimize this effect. One would be to alter the pace of modernizing the strategic nuclear forces. For example, the Congress could cancel procurement of the B-1 bomber and expedite development of a new bomber with the "stealth" technology, while increasing the number of existing B-52 bombers on ready alert. Together, the strategic options discussed in Chapter III could reduce defense budget authority by a total of about $29 billion over the next five years; outlays would be reduced by $23 billion over the period.

Another strategy would concentrate spending for procurement of conventional forces on weapon systems designed primarily for Third World contingencies. Still another would seek alternative methods to accomplish defense missions, such as using battleships in some Navy battle groups in place of aircraft carriers, substituting improved versions of the existing armored personnel carrier for the new infantry fighting vehicle, and buying an alternative mix of aircraft for the Navy. These and other initiatives in the area of conventional forces could reduce defense budget authority over the next five years by a total of about $28 billion. Outlays would be reduced by only about $14 billion over the same period.

Finally, the Congress could seek additional efficiencies in defense pay and support costs. Examples include changes in the COLA formula for retirees and further consolidation of military bases. These and other actions could reduce defense budget authority and outlays by a total of about $7 billion over the next five years. Improvements in the defense acquisition process--for example, promoting competition through more frequent use of two or more producers to manufacture a given weapon system--could also cut costs substantially, though the precise amounts are difficult to estimate.

If all of the above-mentioned options were implemented, defense outlays could be reduced about $15 billion in 1987 and by a total of approximately $44 billion over the 1983-1987 period.

Near-term reductions in defense outlays are difficult to achieve because of the long lag that occurs between obligations and actual outlays. For example, the options outlined in Chapter III would altogether result in budget authority reductions of $14 billion in 1983 but only $1 billion in outlays for that year.

Grants to State and Local Governments. Grants to state and local governments are projected to increase from $49 million in

1982 to $57 million in 1987. They could be reduced through two general approaches (see Chapters VII and VIII for more detailed discussion). 3/ First, the Congress could cut grants for the least needy jurisdictions, focusing assistance on those governments that are least able to provide for themselves. Second, federal aid could be reduced across the board by ending less effective programs or by consolidating existing categorical grants into more general-purpose block grants. Such consolidations could be applied to nutrition programs, capital grants for transportation and community and economic development, and education programs.

Numerous opportunities exist for further targeting federal grants to state and local governments. For example, Community Development Block Grants (CDBGs), Urban Development Action Grants (UDAGs) or mass transit grants could be withdrawn from jurisdictions thought to have the capacity to finance such activities themselves. Alternatively, total spending could be reduced and distributed so as to provide greater per capita amounts to distressed areas and lesser amounts to areas with larger tax bases. Similarly, the General Revenue Sharing program, which provides largely unrestricted fiscal assistance to all general-purpose local governments, could be further targeted by eliminating eligibility of localities with above-average fiscal capacities. Alternatively, portions of present federal programs that are not directed toward special needs could be eliminated--for example, that portion of vocational education grants not restricted to serving disadvantaged students.

Under the grant-consolidation approach, the intent would be to increase the efficiency and effectiveness with which recipient governments spend assistance monies by allowing them more flexibility. This would, however, risk diminishing the degree to which states and localities use their grants to pursue national policy objectives.

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3. Federal grants to state and local governments include funds provided to help support activities for which those governments are often considered primarily responsible. Grants are also provided for assistance payments for individuals (such as Medicaid and Aid to Families with Dependent Children); in these cases, the federal funds fully earmarked for specific individuals merely pass through other levels of government. This section discusses only nonindividual-assistance grants. Individual assistance grants are dealt with elsewhere.

The nutrition programs offer opportunities for increased efficiency through consolidation. At present, the nine major federal nutrition programs use at least 37 different reimbursement schemes. A block grant to the states would simplify administration, enhance state and local flexibility, and possibly permit some federal savings without diminishing nutrition assistance. On the other hand, the achievement of substantial federal savings would require the states either to cut nutrition assistance or to replace from their own resources some of the lost federal funding. The states could protect benefits for the poorest participants by ending subsidies for less needy ones, although this change alone would not compensate for loss of federal funds. Further, if some nutrition programs were forced to close because they had too few participants, the poorest would be adversely affected.

A number of capital grants that are used to maintain, replace, and develop state and local infrastructure could be combined into one large grant the use of which could be restricted to infrastructure development and, possibly, to maintenance. Such a grant could combine CDBGs, mass transit operating and capital grants, economic development grants, portions of highway funds--perhaps even the Environmental Protection Agency (EPA) wastewater treatment grants. If such grants were combined and the federal funding reduced by 20 percent, budget savings of approximately $2.6 billion would be possible in 1987.

As a final example, the now untargeted portion of state vocational education grants could be folded into the recently created elementary and secondary education block grant, and its total funding could be reduced. Again, though, this could result in cuts in the types and extent of services provided.

Other Federal Operations. This spending category, which includes international affairs, some transportation, agriculture, energy, natural resources, science, and similar programs, is projected to increase from $64 billion in 1982 to $69 billion in 1987. Two strategies could be applied to these programs: charging market prices, or at least full costs, for the goods and services the government provides, and reducing subsidies to the private sector.

Market or Full-Cost Pricing: The federal government provides many products and services to individuals and businesses at prices below market values and often below government costs. These implicit subsidies result in inefficient allocation and possible overuse of resources. Federal subsidies may be appropriate if the overall public benefits of a given activity are greater than the private benefits. But this is rarely the case. In most instances, in which beneficiaries are clearly identifiable and public benefits do not justify federal subsidies, the government should charge the market price of the activity or good, or at least recover its costs if there is no discernible market price. Many of the specific options that fall under this strategy would reduce outlays in the various programs since they would raise offsetting receipts. Some options, however, would increase general revenues. Either way, they would lower the deficit.

In the transportation area, the federal government could recover a higher proportion of its costs from users or beneficiaries (see Chapter VII). During 1981, the fees levied on highway users funded about $9.1 billion, or 96 percent, of highway expenditures. Additional 1981 highway outlays--included under other budget functions and funded from general funds--totaled more than $1.0 billion. Airway user fees funded about 42 percent of the $3.3 billion in federal expenditures for airports and airways. Inland waterway user charges funded less than 5 percent of the estimated $700 million spent for inland waterways. Full recovery of all federal costs (including those outside the transportation budget function) for highways, airways, and inland waterways would increase revenues by about $4.0 billion in 1987. Moreover, extending the user-charge principle to federal deep-draft navigation activities could result in additional revenues of about $1.75 billion in 1987 (assuming full recovery of costs). Certain services provided by the Federal Communications Commission, Securities and Exchange Commission, Commodity Futures Trading Commission, and the Department of Commerce could also be subject to full cost recovery.

Applying this strategy to energy and natural resources (see Chapter V) could increase entrance fees to national parks, charge the utility industry the full cost for uranium enrichment and nuclear waste disposal, and even impose a new fee on refined oil products to finance the purchase of oil for the Strategic Petroleum Reserve. Similarly, the federal government could charge market prices for sales of irrigation water and for grazing rights on federal lands. Raising the current energy and resources fees to full-cost recovery or market prices would increase revenues and/or offsetting receipts by about $4.4 billion in 1987. The application of this strategy to all transportation, energy, and natural resource areas would increase revenues and offsetting receipts by about $10.0 billion in 1987.

Reduce Subsidies to Private-Sector Activities: The federal government now subsidizes many private-sector activities either through direct expenditures and grants or through below-market interest rates for loans and loan guarantees. Another strategy would reduce these subsidies by terminating or limiting these direct grants, expenditures, loans, and loan guarantees, and by increasing the rates for all remaining loan programs to the federal cost of borrowing.

The principal categories of this kind of subsidy are export promotion, agriculture, commerce, energy, and transportation. In ~~export~~ promotion, the major program is the Export-Import Bank. In agriculture, there are commodity programs for major crops and milk. Rural areas also benefit from several credit programs, such as those of the Rural Electrification Administration and Farmers Home Administration. The development of new energy technologies is subsidized through various loans and loan guarantees (through the Synthetic Fuels Corporation and other alternative fuel programs) and by direct expenditures (the Clinch River Breeder Reactor and some synthetic fuel programs). The biggest subsidies to private-sector transportation are direct-spending programs for Amtrak and maritime construction and operating programs. Small businesses also receive subsidized aid through the Small Business Administration. By eliminating direct expenditures for these programs and increasing interest rates to market levels on all loan programs, outlays could be reduced by up to $7.1 billion in 1987.

Revenue Strategies

As with outlays, a number of revenue options could substantially shrink the potential deficits over the 1983-1987 period. For example, if the scheduled 1983 tax cut were reduced to 5 percent, revenues could be increased by about $24 billion in 1987. Eliminating both the scheduled 1983 cut and the indexing of tax cuts in 1985 and thereafter would augment revenues by $37 billion in 1984 and $102 billion in 1987. Limiting the mortgage interest tax deduction to $5,000 and eliminating the deductibility of consumer interest payments would increase revenues by $8.8 billion and $9.6 billion, respectively, in 1987. The imposition of a windfall profits tax on decontrolled natural gas could increase revenues by as much as $12 billion in 1983 and 1984. (These and other options, such as value-added or consumption taxes, are discussed in more detail in Chapter XII.)

Realigning Federal, State, and Local Responsibilities

The federal government might also consider realigning federal and nonfederal responsibilities. One approach would be to withdraw federal support for some programs while taking over complete responsibility for others. Alternatively, the federal government might accept responsibility for a variety of benefits for certain segments of the population--the elderly and the disabled, for example--while the states accepted responsibility for providing assistance to the remaining poor.

Any realignment scheme would present problems in defining appropriate federal and nonfederal responsibilities. The important issues in determining appropriate responsibilities include which level of government can most efficiently administer a program, which has most control over costs, and how the program fits into overall national priorities. One such national priority is the extent to which the federal government should close the differences in benefit levels from state to state. Assuring adequate financing for state and local government-provided services may also be a concern. Some of the advantages and disadvantages of changing the jurisdictions responsible for various programs are outlined below.

Elementary and Secondary Education. Since this area is generally assumed to be primarily the responsibility of state and local governments, some observers contend that no federal role is needed. On the other hand, although the federal contribution makes up only about 9 percent of total expenditures for elementary and secondary education, much of it is targeted to disadvantaged students--a goal the Congress felt would not be met uniformly throughout the country without federal aid. If federal assistance ceased, many local educational districts would have difficulty replacing the lost funding from other sources. Nearly 8 percent of all school districts receive more than one-fifth of their revenues from the federal government, and a few receive appreciably more than half.

Health. Responsibility for Medicaid, which the states now share with the federal government, could be assumed entirely by either the states or the federal government. Transferring responsibility to the states could be justified on the basis of their greater ability to control the cost of medical care. Prompted in part by a desire to reduce Medicaid outlays, some states have restrained increases in the cost of hospital care through the use of hospital rate-setting. Moreover, recent relaxation of the federal limits on free choice of providers gives states greater opportunity to obtain lower prices for care provided to Medicaid beneficiaries. Transferring responsibility to the states would enable them to take full advantage of such cost-saving mechanisms. Furthermore, they could tailor their programs to their particular needs. They would also have greater incentive to ensure that only eligible persons actually received benefits. On the other hand, with no federal funding, some states might end or substantially scale down their Medicaid programs, which could widen the current differences in benefit levels among the states.

Shifting Medicaid to the federal government could be supported on grounds that health is a basic right and that access to medical care should not depend upon where one lives. Moreover, the number of persons dependent on publicly financed medical care is influenced in part by national economic conditions, over which states have far less control than the federal government. And because of the effects that economic conditions--especially unemployment--have on state revenues, states' capacities to finance these programs decline in the same periods that expenditures for benefits rise. On the other hand, controlling federal spending would become more difficult if states no longer helped fund this program.

Transportation. Financing of transportation programs such as highways and mass transit is currently shared between federal and state and local governments. A major--and at times overwhelming--advantage in greater state and local funding would be the likelihood of more cost-effective projects, since lower levels of government could pursue their own priorities without federal constraints. Under such an approach, states would also have a better ability to trade off capital costs against operating costs. At present, the federal government funds a much higher percentage of capital than operating costs.

On the other hand, there are two major reasons for the federal government to maintain a role in financing transportation programs. First, national concerns may not be given adequate priority by state or local governments. The need for an interconnecting and properly maintained nationwide road network is a good example; federal financing can help ensure regional coordination. Second, some local or regional projects (notably mass transit ones) may be so large in scale that they cannot be built without supplements to local financing.

Aid to Families with Dependent Children. Full responsibility for the now joint Aid to Families with Dependent Children (AFDC) program could be fully assumed either by the states or by the federal government. Proponents of shifting AFDC to the states maintain that the programs would be run more efficiently, because states would have greater incentive to eliminate fraud and abuse. Since the states already may reap about half of such savings, however, the increased incentives might not be substantial. Those who believe the federal government should be solely responsible for AFDC focus on its sensitivity to general economic conditions and on the desirability of establishing national standards for cash assistance payments, which would be possible if AFDC were funded solely by the federal government.

Realignment of Benefits by Demographic Group. Another approach would be for the federal government to assume the costs of both income assistance and medical care for the elderly and disabled, and for the states to bear the costs for the remaining portion of the low-income population. Because most income security and health programs for the elderly and disabled (Social Security, Medicare, and basic Supplemental Security Income benefits) are already financed and administered by the federal government, moving the remaining programs for these recipients to the federal level would bring about a logical division of responsibility. Moreover, the budgets of some states might be severely strained by increases in the projected number of elderly poor persons over the next several decades.

One argument against this shift is that states would become responsible for programs (those that serve the AFDC population) the costs of which may be particularly affected in the short run by national economic conditions. Moreover, some states might substantially lower benefit levels, thereby increasing state-to-state variation, especially if no federal minimum standards applied.

Financing Considerations and Net Budget Impacts. Any major realignment of responsibilities would raise important issues of how to finance nonfederal activities. A major federal withdrawal from certain policy areas could be a particular problem for jurisdictions that are now most dependent on federal aid or that are least able to raise their own revenues. This problem could be minimized by accompanying any realignment with a transfer of some federal revenue source--for example, the proceeds of certain excise taxes--to needy states and localities, or by retaining some form of revenue sharing directed toward those jurisdictions deemed unable to finance minimally acceptable levels of services on their own. The net impact on the federal budget of any substantial restructuring of responsibilities would depend on the costs of services taken over completely by the federal government, the expenses left to other levels of government, and the degree to which the federal government provided additional revenues to help other governments finance their added responsibilities.

ECONOMIC AND OTHER CONSIDERATIONS

Decisions about major budgetary and tax changes depend primarily upon national priorities and the cost effectiveness of the programs concerned. There are, however, other considerations in making budget decisions. These include the economic impacts of the changes (including their secondary effects on budget outlays), budget offsets among programs, the cumulative effects of reductions in a number of programs, and problems of timing.

Economic Impacts

All the options discussed in this report have effects on economic growth, productivity, inflation, and unemployment. These in turn have secondary impacts on the budget. Thus, savings estimates in the report cannot simply be added up.

For example, a one-year postponement of the personal income tax rate reduction now scheduled for July 1983 would curb federal borrowing and interest rates, thereby easing the burden on credit markets and possibly improving the outlook for investment. At the same time, postponement would lower after-tax income and temporarily dampen the growth of consumer spending. Lower consumer demand would effectively retard the rate of inflation, but it might also raise the level of unemployment, at least for a while. These economic effects would, in turn, slow the growth of federal revenues and increase the growth in outlays for unemployment and other human resource programs. Thus, the secondary budget effects could offset some of the deficit-reducing impact of the tax postponement and of lower interest rates.

The economic and secondary budget impacts of an outlay reduction depend not only on the size of the change, but particularly on whether the program is a transfer, grant, or purchase expenditure. Regardless of the differential impacts, however, most budget reductions generally relieve inflationary pressures and interest rates, but they also temporarily slow economic and revenue growth and lead to unemployment. To the extent that this is so, then federal spending for programs that assist individuals is increased, thereby reducing the federal deficit by less than the amount of the initial budget saving. The net impact of any tax or spending change will, in the final analysis, also depend considerably on the underlying strength and weakness of the economy, as well as on monetary policy at the time that the change becomes effective.

Budget Offsets

Reductions in particular programs can affect spending in other federal programs. The interactions that reduce the net budgetary impacts of the initial cuts occur largely in human resource programs, and arise principally from the fact that the amount of most income assistance benefits depends on a participant's total income, including cash payments from other federal sources.

Interactions that result in total federal savings larger than the initial budget reduction generally occur when eligibility for one program depends on eligibility for another. For example, a person's becoming disqualified for AFDC benefits often ends his eligibility for Medicaid as well, with the effect of reducing federal expenditures in both programs.

The size of the offset to the federal budget depends on the number of people who participate in more than one program, on program rules for determining benefits, and on whether funding is entirely federal or shared with states. These factors cause the size of the budgetary offsets to vary widely. For example, more than half the reduction in spending from an across-the-board reduction in AFDC benefits would be offset by increased outlays for food stamps and housing assistance. This would occur because the federal government would reap only 54 percent of the AFDC savings but would pay all of the increased costs of the other two programs. In contrast, less than 5 percent of a reduction in unemployment insurance benefits would be offset by increased costs for other programs, largely because unemployment recipients are seldom eligible for other income assistance.

Cumulative Effects

Although reductions in any one program may have a limited impact on participating individuals or state and local governments, the cumulative effects of simultaneous reductions in several programs may be substantial, even with the offsetting effects discussed above taken into account. Low-income earners, for example, were affected by the 1981 changes in eligibility and benefit computation rules in both AFDC and food stamps, and those who live in subsidized housing will also pay a higher portion of their incomes in rents.

Cuts in some programs could have a cumulative impact on work incentives. All program reductions should be viewed in this context. For example, changes effected in the 1981 reconciliation act mean that some single-parent families would now be better off financially if they were no longer employed and relied solely on public benefits for support. If many recipients responded to these work disincentives, the policy changes could actually increase, rather than decrease, the federal government's costs for income assistance.

Timing Considerations

Some budget or tax changes may not require phasing in, since they represent marginal reductions across the board and may not impose an especially large burden on any group. For example, reducing the indexing for Social Security benefits to two-thirds of the increase in the CPI would affect all Social Security recipients, but it would only decrease individual benefit levels in 1983 by 2 to 3 percent in real terms if implemented for 1982. The cumulative effects from 1982 through 1987 would be a cut in real benefits of almost 12 percent, however. Postponing the personal income tax reduction scheduled for 1983 would not impose an exceptionally great burden on any particular individuals or groups because the effects would be distributed fairly evenly as a percent of income. On the other hand, a change such as postponing eligibility for federal government pensions past age 55 might require a longer phase-in period--perhaps three to eight years, since it would severely affect a small group of persons whose financial plans are based on certain work and retirement expectations. Similarly, certain tax expenditure changes might require some "grandfathering" or phase-in periods.

CHAPTER III. NATIONAL DEFENSE

The national defense budget function (050) provides funding both for the pay, training, and operations of existing armed forces and for the purchase of new equipment and facilities that update and expand the capabilities of those forces. In fiscal year 1981, budget authority for national defense totaled $180 billion, while outlays equalled $160 billion. 1/

Not all costs related to the military are in this function, however. The group of benefits and payments commonly referred to as veterans' programs are in function 700 and in this report are treated in the chapters on health (Chapter IX) and income security (Chapter X). The function also does not include tax expenditures, such as those stemming from tax-exempt military allowances for food and housing, or the full cost of retirement for civilian employees of the Department of Defense (DoD).

BUDGET HISTORY AND PROJECTIONS

Historical Trends, 1970-1981

The first half of the 1970s saw substantial real declines in defense budget authority, following the peak of the Vietnam War. A turning point came in 1975; the latter half of the decade, continuing through 1981, brought substantial real increases in defense spending (see Figure III-1 and Table III-1).

These overall trends are reflected in important changes within the military forces themselves. Numbers of strategic

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1. Budget authority, or the right to make spending commitments, is the best measure of resources for defense and will be used throughout this chapter. Actual defense expenditures, called outlays, often lag budget authority by several years because of the time needed to build weapons. Outlays are important in macroeconomic terms and will also be discussed in this chapter.

Figure III-1.

Budget Authority for National Defense, 1955-1982

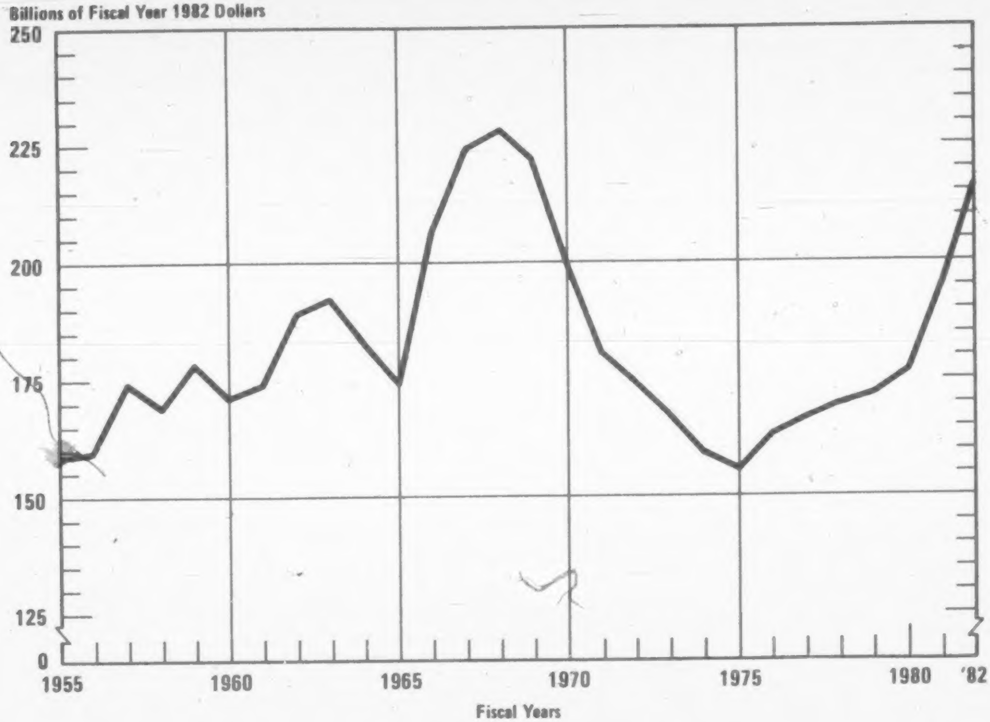

TABLE III-1. BUDGET AUTHORITY AND OUTLAYS FOR NATIONAL DEFENSE
(In billions of dollars)

	Actual		Estimated	Baseline Projection a/	
	1970	1981	1982	1983	1987
Budget Authority	75	180	216	246	422
Outlays	79	160	190	215	373

a. These estimates assume the real growth in defense budget authority found in the First Concurrent Resolution on the Budget for Fiscal Year 1982.

forces remained relatively unchanged over the decade, except for a halving of the number of aircraft committed to continental air defense and a relatively moderate decline in strategic bombers through retirement of outdated systems in the first half of the decade (see Table III-2). Several important qualitative improvements were made in strategic forces, however, such as the increase in numbers of warheads on each strategic missile.

Among conventional or general purpose fighting forces, numbers fell sharply in the first half of the 1970s from Vietnam War levels. Between 1970 and 1975, declines ranging from 20 to 35 percent occurred in Army maneuver battalions, Navy ships, and tactical aircraft. In the latter half of the 1970s, maneuver battalions and tactical aircraft increased, but numbers of ships continued their decline. Accompanying these trends in numbers were improvements in the quality of each force unit, especially among ships and aircraft.

Total military and civilian manpower also declined sharply in the early part of the 1970s from the high levels of the Vietnam War. The downward trend continued, but much more moderately, in the latter half of the 1970s.

In sum, then, the United States generally had fewer armed forces at the end of the 1970s than at the beginning, though the quality of those force units had improved. Moreover, spending trends already under way in the late 1970s suggested that there would be further qualitative improvement and some expansion in forces in the early 1980s.

The 1982 Budget Decisions

In March 1981, the Administration proposed a 1982 defense budget of $226 billion in budget authority, about 15 percent greater than the 1981 budget after adjustment for inflation. The Administration pledged to increase budget authority by about 7 percent more than the rate of inflation in each succeeding year of the five-year period.

Defense spending was largely spared the cuts adopted by the Congress in the 1981 reconcilation act. The defense items included in reconcilation were a switch from twice-a-year cost-of-living increases for retired personnel to once-a-year and changes in

TABLE III-2. U.S. DEFENSE FORCES (End of fiscal year)

Forces	1970	1975	1980
Strategic Forces (in numbers of units)			
Intercontinental ballistic missiles	1,057	1,054	1,054
Submarine-launched ballistic missiles	656	656	640 a/
Strategic bomber aircraft (PAA) b/	469	396	376
Air defense aircraft (PAA) b/	583	376	273
General Purpose Forces (in numbers of units)			
Active Army maneuver battalions c/	187	151	168
Active fleet ships (includes MSC) d/	774	514	478
Tactical fighter aircraft (PAA) b/ e/	2,820	1,958	2,606
Total Manpower, Military and Civilian (in thousands)	4,330	3,205	3,036

a. By the end of fiscal year 1981, this number had dropped to 544. This reflects the termination of operations of seven Polaris submarines in their ballistic missile role.

b. Primary aircraft authorization, a measure of aircraft available to the operational commander.

c. Includes airborne, airmobile, tank, infantry, ranger, and mechanized infantry battalions.

d. Military Sealift Command.

e. All services.

military survivor benefits. Together, these reduced 1982 defense budget authority by a total of about $0.4 billion, or less than 0.2 percent. 2/

The Administration itself made more substantial cuts in defense during the year. Its October budget revisions reduced the March request for 1982 budget authority by $8 billion and outlays by about $2 billion. The October cuts were generally concentrated in procurement. They also included early retirements of older forces, including some ships and the aging Titan missile system.

During the final days of the first session, the 97th Congress completed action on 1982 defense spending, providing a record $216 billion in budget authority. Outlays are estimated at $190 billion. 3/ Outlays are lower than budget authority because much of the expanded defense program focused on procurement, where outlays lag budget authority.

Baseline Projections, 1983-1987

As of this report's issuance, the Administration has not yet publicly released its 1983-1987 plan for defense spending. For purposes of analysis, CBO has projected the funds available for the defense function under two sets of assumptions. One set of assumptions begins with the defense program approved by the Congress for 1982 and then, in the years beyond 1982, procures the numbers of weapons specified in the Administration's October defense plans, modified where CBO believes the Congress intended

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2. Increased sales from the strategic materials stockpile, which were authorized in the reconciliation legislation, were severely restricted by appropriation action and will not result in substantial savings.

3. These figures include estimates of the supplementals for military and civilian pay. The defense appropriation bill enacted during the first session of the 97th Congress did not fund the full costs of pay raises for military and civilian employees of the Department of Defense. Supplemental appropriations will be considered in the first months of the second session.

changes. This version does not allow any real increases in pay or operating costs beyond those dictated by increases in numbers of forces. These assumptions result in modest real increases in defense budget authority (see Chapter II). In both the First and Second Concurrent Resolutions on the Budget for Fiscal Year 1982, however, the Congress planned on larger real increases, at least for fiscal years 1983 and 1984. Thus, a second set of assumptions projects defense spending assuming that the real rates of growth specified in the resolution--about 7 percent a year--continue throughout the five-year period, 1983-1987.

Since these higher estimates may best reflect the intentions of the Congress and the Administration, this chapter concentrates on them. This higher version of the CBO baseline shows defense budget authority increasing from $246 billion in 1983 to $422 billion in 1987. Inflation assumptions in this estimate are those of the CBO February economic report, The Prospects for Economic Recovery.

While the Administration has not specified in public documents the details for future defense spending, some general trends seem clear. Manpower numbers are not likely to increase substantially; thus manpower costs will not go up by much more than the rate of inflation. Operating accounts may be increased by more than the amount of inflation to improve readiness. But the largest increases are likely to come in procurement, as the Administration expands and upgrades the military forces.

Strategic forces will receive substantial added funding under the Administration's plans. In the first few years, most of the added funds will go to improve strategic offensive forces: to develop and deploy two manned bombers, to deploy a limited version of the new MX land-based missile, to continue increasing the size and capability of the submarine-based leg of the "triad," and for other improvements. In the latter part of the five-year period, new funds may also go to strategic defensive systems, such as new aircraft to improve the continental U.S. air defense.

As for conventional forces, ships will be bought to increase the size of the Navy gradually, with emphasis on highly capable vessels such as aircraft carriers, AEGIS cruisers, and nuclear submarines. There will be funds for continued modernization of tactical aircraft, particularly Navy tactical air forces. Numbers of Army units will not increase substantially, but the Army will continue its extensive modernization programs, featuring the new M1 tank and Fighting Vehicle System.

BUDGET STRATEGIES: PRIORITIES IN DEFENSE

In the past year, there has been substantial debate within the Administration and the Congress over the size and nature of this proposed defense buildup. The Administration itself reduced the 1982 request in defense spending in its October budget revisions. While defense spending will almost certainly continue to grow, the Department of Defense may be forced to consider revision or elimination of selected lower-priority programs.

Any attempt to establish funding priorities among defense programs requires making difficult judgments about the adequacy of existing forces as well as the nature and immediacy of their tasks. While it is unlikely that lowering the rate of growth of defense spending can be accomplished in any substantial area without some reduction in military capability, that reduction might be more acceptable in some areas than in others, or more in keeping with an overall defense strategy. For example, it might be preferable to scale back somewhat on improvements aimed primarily at NATO forces while keeping up increases in projection forces aimed more at Third World contingencies where confrontation is considered more likely. Similarly, cutbacks of certain weapons with cost or technical problems might be a good deal more palatable than would reductions of systems meeting performance specifications and schedules. Defense spending for pay and support might also be reduced. The next sections in this chapter illustrate several broad strategies that might guide efforts to this end:

- Altering the composition of the strategic nuclear force buildup;
- Shifting program emphasis to improve U.S. projection forces;
- Seeking alternative approaches to accomplish existing missions; and
- Changing policies regarding pay, support, and acquisition.

As these options will suggest, substantial changes can be made in defense budget authority and outlays over the next five years.

Changes in outlays during the budget year are much more difficult to achieve, however, because of the long lag between obligations for procurement of weapons and actual outlays.

Altering the Composition of the Strategic Nuclear Force Buildup

In October 1981, the Administration announced its decisions on updating U.S. strategic forces. In constant dollars of budget authority, the cost of operating existing forces and updating those forces will total $180 billion over the next six years. The Administration's decisions have provoked a wide-ranging debate in the Congress, on grounds both of the cost of the program and of its projected effectiveness. Despite the prolonged debate, the Congress made no substantial change in the Administration plans when it passed the fiscal year 1982 funding for the Department of Defense.

The Congress could, however, choose to reduce defense spending by altering the composition of the strategic force buildup. The following section provides examples of possible changes. Electing to make these changes would represent a Congressional judgment that a less expensive set of programs than those selected by the Administration might satisfy basic strategic force objectives.

Leapfrog the B-1 Bomber and Proceed Directly to an Advanced Technology Bomber While Increasing B-52 Alert Rates. B-52 bombers--which continue to be the backbone of the strategic bomber forces--average over 20 years of age, though they have been frequently updated with new components and are currently undergoing a major modernization. The Air Force had intended to replace them with the B-1 in the 1970s. President Carter cancelled the B-1 program in 1977, choosing instead to extend the useful life of the B-52s and increase their effectiveness by fitting them with cruise missiles. 4/ The substantially smaller cruise missile was judged to have a better chance of evading Soviet air defenses than the

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4. Cruise missiles resemble relatively small, unmanned airplanes. They fly close to the ground and guide themselves to their targets by matching topographical features with electronic maps stored in their computers.

B-52. The first squadron of B-52s modified to carry cruise missiles will be available in December 1982. Over the objections of the Carter Administration, the 96th Congress directed development of a bomber that could be available by 1987--either a modified form of the B-1, a revamped FB-111 aircraft, or an advanced technology bomber (ATB) incorporating new radar-evading materials and design commonly referred to as "stealth" technology.

The Reagan Administration has proposed two concurrent programs for the modernization of the bomber force: deployment of a version of the B-1 to be available by late 1986; and development of an ATB, with initial deployment planned in the early 1990s. As the ATB bomber is phased into the force, B-1s would be fitted with cruise missiles. B-1s would also deliver conventional munitions in theaters of operation other than the central Soviet Union. As B-1 and ATB aircraft are fielded, the B-52s would gradually be retired.

The Congress could choose to leapfrog the Administration's plans for the B-1 in favor of the ATB. To compensate for cancellation of the B-1, the Air Force could accelerate development of the ATB bomber, proceed with B-52 cruise missile conversion, and increase the number of B-52 aircraft maintained on regular peacetime ("day-to-day") alert from 30 to 40 percent of the bomber force. The approximate five-year budgetary savings of these three changes relative to the possible Administration proposal total $23.6 billion in budget authority (see Table III-3). In addition, a significant amount of the $2.1 billion authorized in 1982 could be saved if the Administration program were terminated. 5/ The Administration had not as of the issuance of this report publicly announced its procurement plan for the B-1 or other weapons. Hence the savings in this and subsequent options are measured against possible Administration plans. Table C-1 in Appendix C details the assumptions that this option makes about possible plans. Costs of this and other options will probably change when final Administration plans are known.

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5. The ATB or "stealth" bomber program remains a highly classified activity. The costs or feasibility of accelerating ATB development cannot be identified in a public document. CBO has assumed that the $2.1 billion (in inflated dollars) for B-1 research and development could be used to speed the ATB program.

TABLE III-3. POTENTIAL SAVINGS RELATIVE TO POSSIBLE ADMINISTRATION PROGRAM, FISCAL YEARS 1983-1987 (In billions of dollars) a/

	1983	1984	1985	1986	1987	Total b/
			Budget Authority			
Leapfrog B-1	3.5	6.2	7.2	6.9	-0.2	23.6
Modify Tanker Re-engining	0.5	1.0	1.2	1.3	1.3	5.3
Modify Navy Battle Groups	7.0	---	---	---	---	7.0
Restructure Navy Air Defenses	1.1	1.1	1.2	2.8	3.0	9.2
Procure Conventional Submarines	0.7	0.5	0.9	0.6	0.4	3.1
Limit M1 Tank Buy	-0.2	0.4	0.4	0.3	0.3	1.1
Alter Fighting Vehicle Program	0.1	0.2	0.1	0.4	0.2	1.0
Revise Navy Air Modernization	0.9	1.4	1.5	1.7	1.2	6.7
Reduce COLA for Under-60 Retirees	0.2	0.5	0.8	1.1	1.3	3.8
Phase In "High-3" Faster	c/	c/	0.1	0.1	0.2	0.5
Reduce Past Overindexation	0.1	0.2	0.5	0.6	0.7	2.3
Restructure Bases	---	0.1	0.1	0.1	0.2	0.5
Eliminate Reserve Dual Pay	c/	0.1	0.1	0.1	0.1	0.3
Improve Defense Acquisition	d/	d/	d/	d/	d/	d/
Total	13.9	11.7	14.1	16.0	8.7	64.4
			Outlays			
Leapfrog B-1	0.2	2.0	4.7	6.3	6.2	19.4
Modify Tanker Re-engining	0.1	0.3	0.7	1.1	1.2	3.4
Modify Navy Battle Groups	0.2	0.8	1.3	1.3	1.3	4.9
Restructure Navy Air Defenses	c/	0.1	0.3	0.6	1.0	2.0
Procure Conventional Submarines	c/	0.1	0.2	0.3	0.5	1.1
Limit M1 Tank Buy	c/	-0.1	0.1	0.3	0.3	0.6
Alter Fighting Vehicle Program	c/	0.1	0.1	0.1	0.3	0.6
Revise Navy Air Modernization	0.1	0.6	1.1	1.4	1.5	4.7
Reduce COLA for Under-60 Retirees	0.2	0.5	0.8	1.1	1.3	3.8
Phase In "High-3" Faster	c/	c/	0.1	0.1	0.2	0.5
Reduce Past Overindexation	0.1	0.2	0.5	0.6	0.7	2.3
Restructure Bases	---	0.1	0.1	0.1	0.2	0.5
Eliminate Reserve Dual Pay	c/	0.1	0.1	0.1	0.1	0.3
Improve Defense Acquisition	d/	d/	d/	d/	d/	d/
Total	0.9	4.8	10.1	13.4	14.8	44.1

a. See Appendix C for comparison of CBO baseline and possible Administration program.

b. Details may not add to totals because of rounding.

c. Less than $50 million.

d. Specific estimates of savings not available.

Some might question whether the B-1 as a near-term penetrating bomber, to be followed quickly by the ATB, would be worth the great expense of the program. The B-1 might cost from $200 million to $260 million per plane in constant 1981 dollars, depending on features added to the aircraft, and potentially as much as $400 million in inflated dollars. 6/ Yet the B-1 may provide critical capabilities for only a few years. Congressional review of the Administration's strategic program brought to light considerable disagreement over the penetration capabilities of the B-1. Secretary of Defense Weinberger initially expressed doubt that the B-1 could successfully penetrate Soviet airspace after 1990, though he subsequently stated officially that the B-1 would operate as a penetrating bomber well into the 1990s. Many believe, however, that in the years beyond 1990 successful penetration will depend primarily on the advanced technology bomber. Once the ATB becomes available, the B-1 will probably revert to the roles of cruise missile carrier and conventional bomber. The Air Force has judged, however, that B-52 bombers can fulfill these two roles until the year 2000. Thus it is not clear whether deployment of the B-1, primarily to increase chances of penetrating Soviet airspace for a period of four to six years, merits so great an expenditure. In addition, a number of officials have expressed concern that the expense of the B-1 program might force a serious delay or even cancellation of the ATB program, which is critical to the long-term viability of the bomber force.

Some of the savings from cancelling the B-1 program could be used to finance higher alert rates for existing B-52s. This is the fastest and least expensive means to increase nuclear force levels on peacetime alert until new bombers can be fielded. (Obviously, it would not increase the total number of weapons carried if all the forces had been "generated" or put on alert because of crisis conditions.)

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6. The Administration has testified that the B-1 program is expected to cost slightly more than $20 billion (in constant 1981 dollars) for 100 aircraft. The General Accounting Office estimates that program costs might reach $26 billion (in constant 1981 dollars), which could amount to some $39.8 billion in inflated dollars.

The primary risk of this option is that deployment of an advanced technology bomber might be subject to delay because of problems in development or production. There are some large areas of technical uncertainty with the "stealth" program. Should difficulties in development emerge, the Air Force would probably choose to retain a portion of the B-52 force in a penetrating bomber role into the 1990s, together with the 60 FB-111 aircraft, despite the difficulties these aircraft would face against expected improvements in Soviet air defenses.

In addition, this option would delay procurement of a new aircraft to replace the B-52 as a cruise missile carrier. It is doubtful that an ATB designed to penetrate Soviet airspace would be well suited to carry either cruise missiles or large quantities of conventional munitions. While B-52s could fulfill this mission until the year 2000, they will probably not sustain operations indefinitely. If the B-1 is not built now, a new aircraft will have to be procured beginning in the 1990s to replace the B-52s in these roles.

Finally, cancellation of the B-1 program could affect the credibility of the U.S. commitment to strengthen strategic nuclear forces in the near term, especially in light of Administration statements about the need to counter rising Soviet nuclear capability. While increasing B-52 alert rates would add to peacetime capabilities faster than would the B-1, cancellation of the B-1 program might be seen as a sign of unwillingness to support the expense required to counter the Soviet challenge.

Modify the Tanker Re-engining Program. The Strategic Air Command (SAC) operates 615 KC-135 aircraft (an early version of the Boeing 707) that serve as tankers to extend the range of bomber and other military aircraft. In recent years, the Air Force has contended that current tanker resources are inadequate for two reasons. First, a far larger number of military aircraft are potential users of aerial refueling today than in the past, when only bombers were likely users. The Air Force, for example, foresees substantial aerial refueling requirements for fighters or transports in the event of a NATO conflict or of a need to project forces to a distant theater such as the Persian Gulf. Second, current Air Force plans to modify B-52s with cruise missiles will temporarily increase tanker requirements. To satisfy all such demands, the Air Force has indicated that as many as 1,000 KC-135 tankers or their equivalent will be needed into the mid-1980s, while only 615 are currently available.

To meet that shortfall, the Air Force has proposed to install new-generation CFM-56 engines on existing KC-135 tankers. With these more powerful and more efficient engines, the tankers could carry greater fuel payloads while using less fuel for their own operations.

In the past year, an alternative re-engining program has been proposed that would install older engines currently used on 707s that are being retired from commercial service. These older engines (designated JT3Ds) would be thoroughly overhauled and checked before installation. The JT3D does not match all the performance characteristics of the CFM-56, but is substantially better than existing engines on the KC-135s. Air Force performance data indicate that the JT3D engine is an effective substitute for the CFM-56 on a large number of SAC refueling missions. It is dramatically more attractive on acquisition cost grounds: where the CFM-56 re-engining would cost approximately $19.3 million (in constant 1983 dollars) per aircraft, the JT3D modification would cost $6.9 million.

If the Congress were to terminate the CFM-56 re-engining program in favor of re-engining 192 aircraft with the JT3D engine, this could save $5.3 billion in budget authority over the next five years relative to possible Administration plans (see Table III-3 and Table C-2 in Appendix C). Enough JT3D engines should be available to accomplish this program. 7/

This approach would provide, at one-fourth to one-third the cost, about 95 percent of the refueling capability of the Administration program through the 1980s, when demands will be at a peak. Both this option and the Administration program should meet all demands by 1990, when changes in the types of aircraft and their missions will result in lower refueling requirements.

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7. In planning for fiscal year 1983, the Air Force actively considered buying 96 JT3D-fitted aircraft. The Congress could direct the Air Force to pursue this option, buying 96 aircraft from U.S. carriers. Purchases beyond the 96 could well be more difficult and expensive, though by 1985 they should be readily available; environmental and noise regulations that take effect in 1985 prevent their use in commercial operations.

The JT3D-modified tanker would not equal the full potential performance of the CFM-56, however, and on certain missions their performance differences are substantial. Thus the CFM-56 provides more flexibility of response to possible changes in missions. The CFM-56 is also about twice as quiet as the JT3D, which in some areas near cities may be an important feature. 8/

Shifting Program Emphasis to Improve U.S. Projection Forces

In the last decade, defense programs have emphasized the need to strengthen NATO defenses. To that end, the United States launched major programs to procure new equipment and induce modernization efforts by its allies. Recently, however, many defense analysts have felt that a NATO conflict, while certainly the most stressful contkngency for planning purposes, has become less likely; they feel that the chances of conflict are now greater in peripheral areas. Indeed, Secretary Weinberger has reportedly suggested that U.S. confrontation with the Soviet Union, if it were to occur, would soon become global in scale, necessitating more numerous, though perhaps somewhat less capable, U.S. forces. This emphasis may suggest some alternative approaches to modernizing defense forces.

Modify and Expand the Navy Battle Group Structure. For many years, the Navy has maintained continuous peacetime carrier battle group deployments in the Western Pacific and Mediterranean Sea areas. Recently, especially with tensions in the Persian Gulf region, the Navy has had to deploy carrier battle groups in the Indian Ocean while attempting to maintain its traditional force deployments elsewhere. Such extended deployments keep ships on station for longer periods and adversely affect maintenance, training, and rotation schedules. The Navy has argued that its current global commitments necessitate an expansion of carrier battle groups.

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8. One of the reasons JT3D engines are becoming available is that they cannot meet future noise and pollution standards for commercial jet aircraft in the mid-1980s. DoD is exempted from those regulations, however. And the JT3D is still substantially quieter than the current engines on the tankers.

The Navy has indicated its objective to increase the number of deployable carrier battle groups from the present 12 to 15, requiring an increase of three aircraft carriers and three carrier air wings in the active fleet. 9/ To that end the Administration may propose authorization over the next five years of two additional nuclear-powered carriers (CVNs), which would be delivered in the early 1990s or perhaps earlier. It also plans to reactivate four Iowa-class battleships and fit them with about 30 cruise missiles each.

As an alternative to the Administration plan, the Congress could direct the Navy to retain its present posture of 12 deployable carriers and form four additional battle groups around the four reactivated battleships. The two new carriers planned for the next five years would not be procured. Over the next five years, savings from this approach would amount to about $7 billion in budget authority relative to the possible Administration program (see Table III-3 and Table C-3 in Appendix C). Eventually, procurement savings under this option would equal almost $37 billion (in constant 1983 dollars). The $37 billion reflects savings from avoiding procurement of three carriers and their aircraft plus 12 escort ships (see Table C-3 in Appendix C). The saving might be partially offset if a decision were made to provide some aircraft capability and aircraft on the battleships.

This approach would expand the number of deployable battle groups from 12 to 16 by the mid-1980s compared with 15 in the early 1990s under the Navy objective. These new battleship battle groups would expand the ability to support peacetime deployments and could

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9. The precise plan to build a 15-carrier force has not been spelled out. Initially, Navy plans called for retaining the two oldest active carriers--the Midway and the Coral Sea--through the 1980s rather than retiring them as the two carriers currently under construction were deployed. They would be retired later, probably when two additional carriers to be authorized in the 1980s are delivered to the Navy. Keeping the Midway and the Coral Sea, plus the two carriers now under construction, would increase the number of deployable carriers to 14 in the 1980s. To get to 15, the Navy planned to reactivate a mothballed carrier, the Oriskany. The Congress canceled plans for the Oriskany.

be used in appropriate combat environments, such as support of amphibious operations, during wartime. For offensive strikes, in contrast to the tactical aircraft used from aircraft carriers, the battleships would use their cruise missiles as well as their existing 16-inch guns.

To maximize the autonomy and flexibility of the battleships, modification plans in the late 1980s could include a flight deck and support facilities for a detachment of vertical/short-take-off-and-landing (V/STOL) aircraft or helicopters. But even without such facilities, the modified battleships could operate with the support of land-based aircraft, helicopters from accompanying destroyers and cruisers, and, in the future, aircraft from new large amphibious ships (LHAs or LHDXs) that could support V/STOL or helicopter operations.

Although more aircraft carriers are clearly desirable for any war-fighting situation, the justification for increasing the number of carriers in the fleet is based in part upon the need to support worldwide U.S. peacetime deployment commitments. Arguably, it is not really necessary to support all of these deployment commitments with aircraft carriers. The battleships are large, impressive ships capable of establishing a credible U.S. naval presence. Rather than maintaining two carriers in the Indian Ocean, for example, the Navy could use one carrier battle group and one battleship battle group. A battleship battle group would be as powerful as the Soviet battle groups now deployed in the Indian Ocean and far more capable when paired with an aircraft carrier. In this way the battleships would be performing a logical and useful role, and they could be made available about five years sooner than new aircraft carriers. Such an alternative will be much more responsive to the need for relatively near-term expansion of the global naval force projection.

Battleships are not as powerful and versatile as modern aircraft carriers, however. They do not have the wide-ranging surveillance and long-range strike capability inherent to an aircraft carrier with as many as 90 manned aircraft. Nevertheless, if fitted with a flight deck and support facility for about 12 helicopters or V/STOL aircraft, the battleships--along with a complement of air defense ships--could operate with independence and effectiveness in appropriate missions, using cruise missiles against distant targets. Otherwise they would have to operate with the support of land-based aircraft, in a manner similar to that of current Soviet naval forces, or along with ships capable of supporting aircraft.

This option, which results in a Navy with 12 deployable aircraft carriers and four battleships, is clearly not as powerful as the force of 15 deployable aircraft carriers and four battleships that would eventually result from the Administration's program. It would, however, provide additional deployment forces in a timely manner and at a substantially lower cost.

Restructure the Modernization of Naval Air Defenses. In the 1960s, the Navy embarked on an ambitious program to improve naval air defense systems to combat Soviet developments in tactical missiles. Today the centerpiece of that program is the CG-47-class cruiser with the AEGIS air defense system, featuring a new and more capable tracking radar and other improvements. The Navy is also procuring a new anti-air warfare (AAW) missile for surface ships called the Standard Missile 2 (SM-2), which incorporates substantial improvements (including longer-range and multiple-target engagement capability) over an earlier version called the Standard Missile 1 (SM-1). Most AAW systems in the Navy today use the SM-1 missile and are incompatible with the SM-2.

In fact, the only new ships currently in existence or authorized that are compatible with the SM-2 missile are the CG-47-class AEGIS cruisers that will cost over $1 billion each. 10/ The Administration may propose procuring 17 CG-47s over the next five years at the rate of 3 to 4 per year. There is no current program to provide an SM-2 capability to the DD-963-class destroyers or to the FFG-7-class frigates that form the bulk of recent surface combatant construction. The likely Administration program, therefore, will result in the SM-2 missile and the most recent air defense technology being used by only a relatively small number of very expensive new ships plus some older Tartar and Terrier ships. 11/

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10. The SM-2 missile would also be used by the DDGX, a ship still being designed and not yet authorized, but expected to cost only marginally less than ships of the CG-47 class.

11. The SM-2 missile can be backfitted into ships equipped with the older Tartar and Terrier AAW systems. Such modification results in a substantial improvement in AAW capability, but many of these ships are now well into their second decade of service.

The Congress could choose an alternative approach to naval air defense modernization, proceeding with the AEGIS program on a somewhat smaller scale, and using the savings to improve substantially air defense capabilities on a much larger number of surface combatants. The Congress could, for example, limit procurement of CG-47 AEGIS cruisers over the next five years to 10, rather than 17 that may be planned. Program savings could be used to develop a new terminal engagement radar (TER)--a fire control system for which prototypes exist--and field it aboard DD-963 and FFG-7 combatants. Such a fire control system would include an electronically controlled radar that can scan wide areas, track targets, and illuminate those targets for the attacking SM-2 missiles. Working with currently installed air search radars, it would permit multiple target engagement on a much larger fleet of ships. 12/ This new fire control system would be installed aboard 31 DD-963s (which would also be equipped with a vertical launch system) as well as aboard approximately 50 FFG-7-class frigates. This alternative would also procure 4,300 additional SM-2 missiles for this expanded air defense fleet. Together, these actions would add 81 ships with modern multiple-target, long-range air defense capability, giving the Navy greater flexibility to deploy its forces worldwide against a distributed Soviet threat while still providing a substantial fleet of AEGIS cruisers.

Moreover, when developed, a terminal engagement radar could be retrofitted into the AEGIS system and the new package would be even more capable than today's AEGIS. As such, the TER might be considered an important enhancement program for AEGIS, in addition to the benefit of improving older AAW systems.

While distributing air defense capability more widely, and perhaps improving AEGIS, this option, relative to the possible Administration approach, would reduce costs by $9.2 billion in budget authority over the next five years (see Table III-3 and Table C-4 in Appendix C). Savings over the long run would be less because much of the added costs associated with this upgrade program would occur beyond the five-year period. Nonetheless,

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12. For a discussion of the terminal engagement radar, also known as the agile beam fire control system, see Congressional Budget Office, Naval Surface Combatants in the 1990s: Prospects and Possibilities (April 1981), pp. 28-33.

total program savings in constant 1983 dollars would still amount to about $2 billion.

The primary adverse consequence of this alternative would be to create a temporary period in which fewer AEGIS ships were being deployed before the new air defense system had been fully developed and retrofitted aboard existing ships. It takes four to five years to build an AEGIS cruiser. It would likely take four to seven years to develop, test, and begin installing the new TER fire control system along with SM-2 missiles on DD-963s and FFG-7s.

Also, while the TER system would be a powerful improvement to existing systems, it lacks the operating potential of the full AEGIS system. Moreover, this option requires a package of research and development, procurement, and backfit initiatives that are uncertain in cost and schedule. Engineering development proposals have been offered by several defense contractors to the Navy, however, and an accelerated development might be able to proceed quickly.

Seeking Alternative Approaches to Accomplish Existing Missions

The cost and complexity of modern weapon systems has been a major concern of the Congress in recent years. Unit costs of some systems have skyrocketed, while at the same time questions continue to be raised about the effectiveness and reliability of some of the systems. Cost and complexity factors frequently induce the military services, faced with constrained budgets, to focus development and procurement efforts on a few systems, sometimes at the expense of less costly alternatives that could effectively complement major new systems and even sometimes replace them. Pursuing complementary or alternative programs might serve to limit total program costs. Such an approach rarely offers large budget savings immediately, however, since near-term development efforts are necessary at the same time that only marginal reductions can be imposed on major new systems. Nonetheless, the following section describes several alternatives to current programs that could eventually lower costs.

Procure Conventional Submarines to Complement Nuclear Attack Submarines. The Administration has established a force level goal of 100 nuclear attack submarines for the Navy. Currently, 86 nuclear attack submarines and 5 diesel-electric submarines are in commission. In addition, 21 SSN-688-class nuclear attack submarines are under construction or authorized; so the Navy should reach its goal of 100 submarines in a few years. Starting in the mid-1980s, however, the force level will decline unless older submarines that are retired are replaced by adequate numbers of new submarines (4 ships per year for a 100-ship force, assuming a 25-year life, or 3-1/3 ships per year for a 30-year life). The Administration may propose authorizing two to four new SSN-688-class submarines per year at a cost of about $740 million per ship. (Costs are those reported in the Congressional Data Sheets for the 1982 President's budget.) The Navy is committed to an all-nuclear attack submarine force and plans no purchase of new-generation diesel-electric submarines.

Nuclear-powered submarines enjoy substantial advantages because of their unlimited submerged endurance. Diesel-electric submarines can, however, be very effective in a number of important missions. These include submarine barrier operations and operations in shallow water where quietness and smaller size are particularly important. 13/ A modern diesel-electric submarine operating on its batteries is quieter than a nuclear submarine, an important advantage in undersea warfare. But the chief advantage of non-nuclear submarines is their substantially lower cost, on the order of one-fourth that of an SSN-688-class submarine. 14/ Although diesel-electric submarines cannot perform all of the

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13. CBO analysis suggests that, where 19 SSN-688 submarines are needed to perform barrier operations at the Greenland-Iceland-United Kingdom gap, it would take only 22 new-generation diesel-electric submarines to provide equal coverage. See Congressional Budget Office, Shaping the General Purpose Navy of the Eighties: Issues for Fiscal Years 1981-1985 (January 1980), especially pp. 127-40. That analysis concluded that new-generation diesel-electric submarines can be over two times more cost-effective in such barrier missions.

14. A German shipbuilding firm, Howaldtswerke-Deutsche Werft, has formally offered to design and build a fully equipped diesel-electric submarine of 2,600 tons submerged displacement for the U.S. Navy for the price of $200 million (in fiscal year 1981 dollars). The firm estimates that follow-on ships would cost about $100 million each. To reflect possible cost

missions that might be undertaken by nuclear submarines, diesel-electric submarines could be assigned to barriers and other suitable missions, freeing nuclear submarines for more demanding tasks.

In view of the advantage of a mixed force, the Congress could choose to cut back procurement of SSN-688-class nuclear attack submarines by one per year over the next five years and use those savings to finance development and initial procurement of six new-generation diesel-electric submarines. Such an approach might provide roughly equal coverage on a barrier and, over the next five years, would save $3.1 billion in budget authority (see Table III-3 and Table C-5 in Appendix C). Further savings would be possible, or more submarines could be bought with the same funds, if more diesel-electric submarines were substituted for nuclear vessels. For example, over the long run, 20 diesel-electric submarines could be substituted for 10 nuclear submarines and still save over $4 billion (in constant 1983 dollars).

This program would require cutting back SSN-688 production in the near term in favor of an alternative that would take several years to develop and field. (Conventional diesel-electric submarines are, however, routinely built in other countries and take about half as long to construct as nuclear-powered submarines.) Moreover, conventional submarines could not be a complete substitute for nuclear, since they clearly cannot match the latter in speed and endurance. Fielding a mixed force, however, would free the nuclear submarines for more demanding missions suited to their particular strengths.

Limit M1 Tank Procurement and Supplement It with M60s. The centerpiece of Army equipment modernization plans is the new M1 tank, intended to replace production of the M60 that has been the Army's main battle tank for the past 20 years. Though the M60 is a very capable tank, the M1 has improved armor and armament and is

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growth, this report assumed $250 million for the lead ship and $150 million apiece for follow-on ships. Most likely, were the Navy to pursue such a program, a U.S. shipbuilder would buy the appropriate technical data and licenses to produce the submarines in this country.

judged to have substantially better combat effectiveness than even the M60A3, the latest version of the M60. 15/

While potentially much superior to the M60A3, the M1 has had a tortured development history. It has had persistent reliability and maintenance problems, and has not yet met design specifications in some critical areas. The latest report on the M1 in the official Selected Acquisition Report (SAR) indicates it is still having power train and track durability problems. In addition, the factories have experienced production difficulties that have, to date, limited output to about half of planned rates. Moreover, production costs have increased dramatically: the current SAR places unit production costs in inflated dollars at 97 percent above initial program estimates. 16/

Nonetheless, the Army will increase M1 tank production in 1982 and stop producing M60 tanks except for foreign military sales. The 1982 budget provides for 665 M1s. As of the issuance of this report, Administration plans for 1983 and beyond were not publicly available. Plans announced earlier called for production of 802 M1 tanks in 1983, increasing to 1,080 a year from 1984 through 1987.

As an alternative to these possible Administration plans, the Congress could direct that the Army not increase M1 production above the rate of 720 per year, which was the original goal for this year's production. To compensate for inventory shortfalls, the Congress could direct continued production of the M60A3 tank, at a rate of 30 per month, beginning in 1983. 17/ As a

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15. The M60 upgrade program installs a new ballistics computer, a thermal night sight, and a laser range finder for the M60A1 fire control system.

16. The 97 percent increase is relative to costs estimated at the time when the decision was made to commence full-scale engineering development.

17. Thirty per month is the smallest economical buy for the M60A3. This means that total 1983 tank production under this alternative would be higher than under possible Administration plans.

consequence, total tank production in 1984-1987 would equal planned Army tank production, while the 1983 rate would be slightly higher. Relative to possible Administration plans these two actions would save approximately $1.1 billion in budget authority over the next five years, though there will be some additional costs in 1983 (see Table III-3 and Table C-6 in Appendix C). Further savings could be achieved if the Congress elects to forgo the M60A1 upgrade program now underway. 18/

Choosing this option would ensure continued production of the M60, which might otherwise be terminated in 1982 because of too few requests from foreign customers. Retaining M60 production capability might be important if problems with the M1 are not adequately resolved.

Such an alternative would, however, delay Army tank modernization efforts. While tank inventories would be slightly higher, the tank arsenal in the late 1980s would be composed of 1,522 fewer new-generation M1s, 23 percent fewer than under possible Administration plans. The Army could eventually compensate by extending the production run of the M1 beyond current plans. By 1987, however, the Army would have fewer M1s than originally planned.

Alter the Composition of the Infantry Fighting Vehicle Program. For years the Army has been developing a new infantry fighting vehicle, designated the M2, to replace the old M113 armored personnel carrier. The M2 would be a substantial improvement over the old M113, which provided armored protection for infantry squadrons but had little offensive striking power of its own. The M2, by way of contrast, carries both the TOW antitank missile and a new 25-millimeter automatic cannon. It will also have the speed necessary to keep pace with the M1 tank.

While clearly capable, the M2 has experienced large cost increases in recent years. Indeed, the Congress has already directed the Defense Department to explore the feasibility of a second prime contractor in the hope that competition could hold down costs.

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18. The current program calls for upgrade of M60A1 tanks to M60A3s at the rate of 360 per year and an annual cost of $177 million in constant 1983 dollars.

Despite these cost problems, the likely production program, which may be at a rate of about 60 per month through 1984, could increase to close to about 90 per month in later years. The Congress could alter the Administration program for the M2, choosing to limit production in 1983 and 1984 to 30 per month and to 50 per month in 1985 and beyond. The maximum production capacity of current manufacturing facilities is 30 per month with one shift and 50 with two. In addition to reducing procurement cost, this option would avoid approximately $30 million of funds needed to expand M2 production facilities to achieve a production rate of 90 per month.

To compensate for fewer M2s, the Congress could direct a somewhat different approach to the fighting vehicle. Elements within DoD have examined plans to modify the M113 to improve its effectiveness as an alternative to the M2 fighting vehicle. In particular, the Army could replace one fighting vehicle in each infantry squad with two M113s, equipping one M113 with an improved TOW antitank missile and the other with a 25-millimeter cannon similar to that installed on the M2. This approach would capture much of the fighting capability of the M2, and procurement costs for two modified M113s, equipped as noted above, are estimated to be $0.4 million less than for the one M2 they would replace. Moreover, the operating cost of a battalion equipped with the two modified M113s per squad should be roughly equivalent to that of a battalion equipped with one M2 per squad.

This alternative, then, would purchase 30 M2s per month in 1983 and 1984 and 50 per month thereafter. In addition, the option would buy 80 modified M113s (40 of each type) per month through the five years. Savings relative to the possible Administration program would total $1.0 billion in budget authority over the next five years (see Table III-3 and Table C-7 in Appendix C).

This alternative suggests a new battle concept for the Army that has not been fully explored for its potential advantages or problems. The alternative offers more vehicles and captures much of the M2's fighting capability. But coordinating two infantry fighting vehicles instead of one opens questions regarding battle management and command and control. Also, limiting production of the M2 would largely obviate developing a second producer for the vehicle so as to hold down costs. Nevertheless, the potential savings suggest that the alternative is worth exploring.

Revise the Navy Aircraft Modernization Program. The Navy is in the midst of a major program to modernize Navy and Marine Corps fighter and attack aircraft squadrons. The central component of this program is the F/A-18, a single aircraft designed to function either as a fighter or as an attack aircraft. [19] It was originally developed as a low-cost complement to the more capable and expensive F-14 fighter, and is now intended as a long-term replacement for A-7s used in current light attack squadrons.

Program costs of the F/A-18, which is now entering initial production stages, have increased substantially since development was initiated in 1975. Total program unit costs for the original program have increased by over 60 percent in inflated dollars. The Secretary of the Navy has expressed concern over cost growth, though no program revisions have been suggested. In 1982, the F/A-18 is as expensive as the more capable F-14, though average unit costs for the F/A-18 will decline well below those for the F-14 once efficient production schedules are reached. The F/A-18, however, is and will remain significantly more expensive than the A-7E light attack aircraft it is to replace in carrier attack squadrons.

Current Navy plans call for purchase of 8 additional F-14 squadrons, 16 F/A-18 fighter squadrons (4 for the Navy, 12 for the Marine Corps), and 30 light attack squadrons equipped with the F/A-18.

The Congress could choose an alternative modernization plan that would cancel F-14 purchases after 1983 and replace them with F/A-18s. The alternative would also cancel F/A-18 procurement as light attack replacements for the A-7Es, and field a proposed improvement of the A-7 known as the A-7X. Relative to the possible Administration program, this alternative program would save $6.7 billion in budget authority over the next five years (see Table III-3 and Table C-8 in Appendix C). Nor would savings be limited to just the next five years. By the time the entire modernization plan was completed, total savings would amount to about $11 billion in constant 1983 dollars. This alternative might also result in lower operating costs, since the F-14 requires two persons in the cockpit and so ~~is~~ more expensive to operate than the single-seat F/A-18. If contractor estimates are correct, the A-7X would not cost more to operate than the F/A-18.

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[19] While a single F/A-18 is capable of either fighter or attack missions, training and operating requirements are sufficiently different so that the Navy, in effect, will field F/A-18 attack squadrons and F/A-18 fighter squadrons.

On attack missions, a force updated with the A-7X--rather than the F/A-18--would have more capability to deliver ordnance at all ranges beyond about 500 miles. The A-7X force would be about 10 percent less capable at shorter ranges. Though the Navy in the past has operated at shorter ranges, close-in ranges might be risky in the future because of the threat of attack on the carrier by patrol boats or land-based aircraft. The A-7X would also have a larger engine than the current A-7E as well as some updated electronic components, so that its survival prospects when under attack could approach that of the F/A-18.

Navy fighters have two basic missions--providing extended-range fleet air defense against hostile aircraft launching cruise missiles and acting as escorts for bombers. As an escort, the F/A-18 can generally match the F-14's performance. In the fleet air defense mission, the F/A-18 is not the equal of the F-14, which has greater speed, longer-range missiles and radar, and the ability to attack several hostile aircraft simultaneously. Since there currently are 18 F-14 squadrons, however, most carrier task forces would have some F-14s even under this option. Moreover, the F/A-18 has an added advantage over the F-14 in that it can be used for attack missions when combat situations permit or require it.

Changing Pay, Support, and Acquisition Policies

The rate of growth in defense spending could also be reduced by changes in pay and support policies, and by changes in the way DoD acquires its weapon systems. Indeed, about 38 percent of defense budget authority in 1982 will go for pay, allowances, retirement, and housing costs of civilian and military employees; another 19 percent will pay for operating and maintaining equipment and installations. This section addresses several policy changes that, if implemented in 1983, would lower pay, support, and acquisition costs.

Change Pay and Recruitment Policies. One of the most far-reaching changes would be a move away from the all-volunteer method of attracting military recruits. A return to conscription would affect costs, though perhaps only modestly. If, for example, today's recruit pay rates were maintained and a lottery draft was implemented at the beginning of fiscal year 1983 to make up future shortfalls of volunteers, savings might amount to $125 million in 1983 and $150 million a year in later years. These estimates assume that numbers of military personnel in future years remain at today's levels. If numbers of personnel increase, instituting conscription could avoid substantially larger costs, since manning a larger all-volunteer force could require big pay hikes.

Savings under conscription would also be larger if the Congress cut recruit pay. In 1983, about $4.3 billion will go for basic pay of enlisted persons with one or two years of service. If the Congress enacted conscription and reduced pay for these personnel by dropping enlistment bonuses and eliminating the special pay raises granted during the transition to the all-volunteer force, basic pay costs would go down by about $1.5 billion a year. But higher turnover could raise training, travel, and other costs of first-term personnel by at least $325 million annually. When these increases are coupled with an estimated $75 million cost for Selective Service operations, net annual savings would amount to about $1.1 billion.

Other pay policies might reduce costs even with the all-volunteer force. The recent increases in military pay and allowances--totaling about 30 percent over the last two years--have combined with other factors to improve military recruiting and retention substantially. Annual pay raises that keep pace with those in the private sector should be enough to maintain this improvement. Special increases in compensation above this "keep-pace" level are needed only for those with certain skills of which there is a shortage, such as engineers and nuclear-trained personnel. If any special increases in compensation, such as increases in health benefits or improved educational benefits, are granted to all military personnel, the Congress could hold down costs by reducing the annual pay raise enough to finance part or all of the added costs. Such a policy could still roughly maintain current levels of recruiting and retention. The extent of the savings would depend on the special increases in compensation that are proposed by the Administration.

Change Military Retirement Benefits. In 1982, the military retirement system will provide benefits for about 1.4 million persons at a cost of about $15 billion. Under this system, nondisability retirees earn benefits after 20 or more years of service irrespective of their age or whether they subsequently find employment in the private sector. Those having fewer than 20 years' active and reserve service earn no benefits. Five major studies, plus legislative proposals from two previous administrations, have recommended providing more of the total military compensation package "up front" rather than in retirement years. This would provide mid-career personnel with increased incentives to remain in the service, while reducing the incentive to leave the military immediately after completion of 20 years' service.

The Congress has moved compensation policies in these directions. Retirement benefits for new recruits have been reduced by changing the basis of calculating retirement pay, while retirement benefits for all persons have been reduced through changes in the cost-of-living adjustments provided each year. At the same time, cash bonuses available earlier in military careers have been increased.

The Congress could continue to restructure military retirement pay, perhaps through further limits on cost-of-living adjustments. For example, one option would provide half the regular cost-of-living increase for retirees under age 60, with a catch-up raise at age 60 to make up for the half raises (See Appendix A-050-c). Proponents argue that such a plan would provide incentives for longer careers, which may be desirable, particularly for officers. Such a plan might, however, have adverse effects on retention. Other incentives, such as larger reenlistment bonuses, may be needed to offset negative retention effects in key skills. Without offsets for costs of increased bonuses, which could only be estimated after detailed study, CBO estimates that five-year savings under this option would equal about $3.8 billion. Savings would be delayed if the Congress protected all of today's retirees from any reductions.

The Congress could also phase in, over the next three years, the "high-3" method of calculating retirement pay (see Appendix A-050-b). In 1980, the Congress decided to base military retirement on average pay during the three years when it was highest, but applied the approach only to new recruits. If, over the next three years, high-3 was applied to all personnel, then five-year savings would total $460 million. Such an option would bring the military into line with the Civil Service Retirement system quickly but could reduce overall retention by a modest amount.

The Congress could also modify the military retirement system by providing a uniform annuity for recent retirees and make similar changes for civil service retirees (see Appendix A-600-i). Because retirees receive cost-of-living adjustments based on the CPI rather than military wage increases, benefits paid to those who retired during the decade of the 1970s--when CPI increases were high but wage increases low--sometimes exceeded the amount paid to those who retire today with the same grade and years of service. The Congress could correct these differences by temporarily granting half the normal cost-of-living adjustment to those with higher benefits. Such an approach should save $2.3 billion over the next five years for military retirement alone. Equity may argue for such a policy, since military wages did not keep up with the extraordinary price increases of the 1970s. But opponents would argue that this option represents inequitable treatment of some who served assuming that their retirement pay would be adjusted by the full amount of CPI increases.

Continue Restructuring of Military Bases. The Department of Defense manages over 5,000 installations and properties worldwide. The cost of operating and maintaining these facilities in fiscal year 1982 will be about $20 billion. Since 1969, the department has taken more than 4,000 realignment and closure actions designed to provide a more efficient defense structure and to reduce base operating costs. Further actions may be possible. Indeed, this period of increasing defense budgets may be the best time to attempt these politically difficult changes.

Proponents of further base restructuring point to the wide variation in base operating support costs as an indication of the potential savings from such actions. For example, the cost per person assigned to a mission task at the most expensive base often exceeds that at an average base by three to one and sometimes much more--even after adjusting for base size and type of mission. While many factors influence such cost comparisons, the wide variation suggests that further efficiencies are possible. Proponents also contend that changes in the nation's strategic needs, force levels, and weapons technology demand modifications in the existing basing structure. Such realignments need not eliminate places for reserve unit training or reduce mobilization potential, since bases can be put into caretaker status.

Because estimated savings require detailed reviews of the situation at each base, CBO has no independent estimate of the total savings possible from further base realignments. Over the past year, the Administration has initiated only a very limited number of realignment actions with small budgetary consequences and has not produced any comprehensive package of possible future realignment actions. Discussions have begun within the Administration on possible sale of surplus property held by all federal agencies, but no firm decisions have been reached.

Lacking any detailed plan at this time from the Administration, one basis for an estimate is the Department of Defense's March 1979 base realignment proposals affecting 157 military installations and activities. If the department pursues, and the Congress allows, the remaining realignments in this proposal, DoD estimates that total savings over the next five years would amount to $520 million. These savings would result primarily from a reduction of about 2,700 military and 2,800 civilian positions. Few if any savings would occur in 1983 because of the added costs of construction, transferring employees, and avoiding economic dislocation.

While the continuing buildup in defense may increase the demand on previously underutilized facilities, the major opposition to base realignments stems from the economic dislocation they might produce in communities near the bases--often a cause of intense local concern. Measures can be taken, however, to mitigate this. The Department of Defense states that its Office of Economic Adjustment has been relatively successful in providing planning assistance and ensuring that federal grants and loans are directed to affected communities.

Improved Acquisition Procedures. In 1982, the Department of Defense will buy about $140 billion in goods and services from the private sector. This cost could possibly be reduced, without eliminating any purchases, by improving acquisition procedures through one or more of the following approaches.

Encourage Competition in Defense Industries Through Second Sourcing: There is general agreement that competition holds down prices. One way to increase competition is "second sourcing," or the use of more than one contractor to manufacture a particular weapon. Some studies suggest that second sourcing could produce cost savings of as much as 30 percent for selected items. Although second sourcing is not appropriate for all weapon systems--in some cases, small buy sizes and high fixed production costs make it impractical to have many competing suppliers--the Congress could require that the Defense Department consider it whenever formulating a procurement strategy. Current law encourages second sourcing only when it will improve the department's ability to produce weapons quickly during a wartime mobilization; the Congress could amend the law to encourage second sourcing wherever it might cut costs.

Encourage Economical Buy Sizes: The size of a buy is very important to defense costs. If contractors build facilities capable of producing weapons at a certain rate, but then produce fewer, this often results in much higher unit prices than planned. Because of the importance of economical buy sizes, the Congress might require a short report specifying the economical buy size for existing systems and the planned rate for proposed buys. To limit paperwork, such a report could be limited to major systems. Where proposed buys deviate from the economical rate, the report should note the reason and the unit cost at the economical buy level. Such a report would focus the department's attention on this important topic and allow the Congress to assess fully the costs of departures from economical buy rates.

Economical buy rates demand more than just managerial attention, however; they also require political courage. The Administration and the Congress must be willing to terminate a few programs in times of cutbacks, rather than stretching out many programs over a longer period.

Foster Multiyear Procurement: Multiyear procurement constitutes one of the Administration's major initiatives in the defense acquisition area. Multiyear contracts, which provide for buys over several years with substantial cancellation charges if the buys are not executed, could offer important benefits. They might encourage cheaper bulk buys of parts, foster a stable work force, and facilitate stockpiling of materials needed to avoid production delays. Such benefits might cut costs by 5 to 10 percent. Last year the Congress facilitated use of multiyear contracting by raising the amount that can be paid to a contractor if a multiyear contract is abrogated, and by other revisions in the law.

Improve Congressional Oversight of Weapons Cost Increases: The options just discussed may help control weapons prices and so keep down costs. But, at its heart, the problem of weapons cost growth is one of incentives. Officials at the Department of

Defense, and defense contractors, may be tempted to keep initial cost projections low in order to increase the chances of obtaining funding for their programs. The Congress alone cannot change these incentives; the Department of Defense must take the lead in providing needed management. But the Congress may be able to help through a closer scrutiny of prices.

One approach, included in the last year's defense authorization bill, requires DoD to report to the Congress whenever the program unit cost of a weapons system--as reflected in the Selected Acquisition Reports, or SARs--increases by more than 10 percent for systems in production or 15 percent for systems in research and development. But the SARs may come too late to allow the Congress to consider alternatives to weapon systems that have grown sharply in cost. The Congress could seek earlier warning, perhaps by requiring that DoD include in the SARs some of the more timely cost and performance data now submitted by contractors to the Department of Defense. Early warning of overruns could trigger early Congressional debate over whether the weapon should be procured at the higher cost, or whether alternatives should be pursued.

Options like the four just discussed could eventually reduce costs substantially, but it is difficult to say by how much. Potential savings depend on the peculiarities of individual weapons and must be estimated by the Department of Defense and its contractors. Nonetheless, even small savings in procurement add up. A reduction of 1 percent in overall spending for procurement and research and development would cut costs by about $1.0 billion in budget authority in 1983 and a total of $5.7 billion over the next five years.

CONCLUDING COMMENTS

The preceding discussion has focused on several strategies that the Congress could use to limit increases in defense spending over the next five years. The size of the defense budget points to the importance of decisions about defense spending. The national defense budget function is currently second in size only to the income security budget function (function 600). By 1987, if CBO's economic assumptions and real growth of 7 percent a year for defense are realized, the defense function will be the largest single function.

This chapter offers a wide-ranging set of possible changes in the defense budget. It would not, however, necessarily be desirable to pursue all the changes simultaneously. For example, some proponents of slowing the pace of the strategic force buildup would at the same time wish to devote more resources to strengthening conventional forces.

Moreover, even implementing all the proposed cuts would not result in large reductions in outlays during the next few years. Indeed, if all of the budget-reducing items in this chapter were pursued simultaneously, actual outlays would be reduced by only about $1 billion in 1983 despite reductions of about $14 billion in budget authority (see Table III-3). This happens because most of the cuts are in investment accounts where outlays often occur several years after budget authority is created. Substantially larger reductions in defense outlays in the next few years would require cuts in operating accounts. Yet, increased spending in operating accounts is generally felt to be essential for maintaining military readiness, and cuts in these accounts might therefore be less acceptable.

CHAPTER IV. INTERNATIONAL AFFAIRS

The international affairs budget function (150) includes foreign economic and financial assistance, military assistance, the diplomatic and consular services, foreign information and exchange activities, and international financial programs.

Foreign economic assistance programs include Public Law 480 food aid, which provides both agricultural commodities for distribution abroad (Title II) and financing for sales of U.S. agricultural exports (Titles I and III); the Economic Support Fund (ESF), which provides economic assistance to promote political and economic stability; and contributions to the multilateral development banks--the World Bank, the Inter-American and Asian Development Banks, and the African Development Fund. International financial programs include the Export-Import Bank, which provides both direct loans and loan guarantees aimed at promoting U.S. exports of goods and services.

The foregoing programs affect the spending side of the budget; other international programs affect tax receipts. Domestic International Sales Corporations (DISCs), for example, are intended to promote exports by permitting a corporation to defer payment of income tax on profits. Similarly, the Generalized System of Preferences (GSP) permits a large variety of exports from less-developed countries to enter this country duty free.

BUDGET HISTORY AND PROJECTIONS

Net outlays for the international affairs function rose from $4.3 billion in 1970 to $11.1 billion in 1981 (see Table IV-1). In 1982, net outlays are expected to decline slightly to $11.0 billion. Assuming a continuation of current policies, net outlays are projected to increase from $11.7 billion in 1983 to $14.7 billion in 1987.

Historical Trends, 1970-1981

While net outlays for international affairs rose by almost $7 billion between 1970 and 1981, they declined as a proportion of total federal outlays and of gross national product.

Most of the increase in net outlays occurred between 1973 and 1975 and after 1979. The increase from $4.1 billion in 1973 to

TABLE IV-1. FEDERAL OUTLAYS FOR INTERNATIONAL AFFAIRS
(In billions of dollars)

Program	Actual		Estimated	Baseline Projection	
	1970	1981	1982	1983	1987
Foreign Economic and Financial Assistance					
P.L. 480	0.9	1.3	1.0	1.0	1.3
Functional development assistance	0.6	1.1	1.1	1.2	1.5
Economic Support Fund	0.5	2.1	2.4	2.5	3.2
Multilateral development banks	0.2	1.0	0.9	1.0	1.6
Miscellaneous	0.6	0.8	1.1	1.0	1.4
Subtotal	2.8	6.3	6.5	6.7	9.0
Military Assistance	0.6	1.0	0.8	0.9	1.1
International Financial Programs					
Export-Import Bank	0.2	2.1	1.9	2.1	1.6
Miscellaneous	0.1	-0.1	-0.3	-0.4	-0.3
Subtotal	0.3	2.0	1.6	1.7	1.3
Pay Raises a/	---	---	---	0.1	0.4
Other	0.6	1.8	2.1	2.3	2.9
Total	4.3	11.1	11.0	11.7	14.7

a. Employee compensation is included in the program totals for 1970, 1981, and 1982. In the CBO baseline, the projected pay raises appear in function 920. In this report, they have been allocated to their respective functions for 1983 and 1987 so that the function totals for all five years are compatible.

$6.9 billion in 1975 occurred largely because of rising outlays on military assistance and on the Export-Import Bank. Between 1979 and 1981, net outlays increased from $6.1 billion to $11.1 billion, the bulk of the increase going to the Eximbank and other international financial programs, including the Foreign Military Sales Trust Fund. Higher outlays in the foreign economic and financial assistance subfunction also contributed to the increase.

As a consequence of these differing growth rates, the relative importance of international affairs programs has changed since 1970. Outlays for the Export-Import Bank have risen from approximately 5 percent of the total net outlays for the function in 1970 to over 18 percent in 1981, raising the relative contribution of international financial programs from 7 percent in 1970 to 18 percent in 1981. The share of total net outlays devoted to food aid has declined from over 20 percent to about 12 percent. Multilateral development assistance has maintained approximately the same share of total net outlays. The Economic Support Fund has increased in importance from 11 percent of net outlays in 1970 to almost 19 percent in 1981, while the share of military assistance has declined slightly from about 13 percent to 9 percent.

These changes reflect shifts in the regional focus of aid flows as well as changes in aid policy. Currently, Israel and Egypt have replaced Southeast Asia as the major recipients of U.S. bilateral aid. Reflecting the needs of these countries, an increased proportion of aid resources has been devoted to supporting the balance of payments through the Economic Support Fund, and to financing the purchase of military equipment, while the share of resources devoted to food and infrastructural projects aid has decreased. Policy objectives have also changed. With the adoption of the New Directions legislation in the early 1970s, the emphasis of aid flows shifted from financing basic infrastructure to helping the poorest people within the developing countries through such programs as financing the adoption of appropriate technologies. The increased importance of the Export-Import Bank reflects a heightened interest in export promotion--in support of U.S. domestic and foreign policy objectives.

The 1982 Budget Decisions

In 1982, net outlays for the international affairs function are expected to decline slightly from the 1981 level of $11.1

billion to $11.0 billion. This is more than accounted for by a decrease in the international financial programs subfunction, where outlays are expected to fall from $2.0 billion to $1.6 billion. About half of that decrease will be in net outlays for the Eximbank. The 1981 reconciliation act did not materially affect the 1982 budget decisions except for authorizing the sixth replenishment of the International Development Association and the general capital increase of the World Bank.

Baseline Projections, 1983-1987

Between 1983 and 1987, net outlays for the international affairs function are projected to increase from $11.7 billion to $14.7 billion. Much of this is accounted for by increases in net outlays for the foreign economic and financial assistance subfunction, which are projected to increase from $6.7 billion in 1983 to $9.0 billion in 1987, increasing this subfunction's share of total international affairs outlays from 57 percent to 61 percent. Most of this increase is attributable to increased outlays for the Economic Support Fund and the multilateral development banks. Over this period, net outlays for international financial programs are projected to decline from $1.7 billion in 1983 to $1.3 billion in 1987. Decreased outlays for Eximbank account for all of this decline.

BUDGET STRATEGIES

The Congress could reduce international affairs outlays in at least two ways. It could reduce federal export promotion activities. It could also reassess foreign aid programs in the light of changed economic conditions within the United States and among recipient countries.

Reducing U.S. Export Promotion Efforts

Federal export promotion efforts have been justified primarily on the grounds that they reduce trade balance deficits and increase employment within the United States. In 1981, such programs accounted for about one-fifth of the net outlays for the international affairs function. Other export promotion programs affect the budget primarily by reducing tax receipts, as, for example, Domestic International Sales Corporations. The Treasury estimates that this program alone decreased tax receipts in 1980 by $1.3 billion.

If these programs increased exports by removing market inefficiencies, promoting productivity, or producing wage and price performance superior to that of other countries, they would result in gains for all U.S. citizens. But programs that promote exports by subsidizing exporters do not produce gains for all citizens. At best, such programs produce gains for exporters at the expense of other U.S. citizens; at worst, they produce losses for all U.S. citizens and benefits only for foreigners.

An export subsidy can produce a net gain for the United States if it employs resources that otherwise would have been idle; but there is no reason to believe that export subsidies employ otherwise-idle resources in any systematic way. Export subsidies increase the sales of some products relative to those of other exported and nonexported products; but other macroeconomic policies could be designed to produce more general economic expansion. When the economy is operating near full capacity, the increase in employment in export industries will come at the expense of employment in nonsubsidized industries. Therefore, if export promotion activities continue at all levels of aggregate economic activity, they may expand employment in slack years, but aggravate inflation in other years of high economic activity.

The two major export promotion activities discussed here are the Export-Import Bank and Domestic International Sales Corporations. Since these export promotion activities produce few measurable national economic benefits, the case for national export promotion through subsidization is commensurately weakened. Export promotion can produce local benefits, however, where otherwise unemployed resources are used or when one state or region gains at the expense of another in employment volume or in jobs paying higher wages or requiring more skill. State and local governments might then promote such activities, just as some now offer special loans and tax incentives to desirable firms that locate in their areas.

Export-Import Bank. The Export-Import Bank provides direct loans and loan guarantees to promote the export of U.S. goods and services. In 1981, net outlays of the Eximbank amounted to $2.1 billion, calculated as the difference between Eximbank's cash receipts and expenditures. Cash receipts include net interest earnings, repayments of principal on old loans, and insurance premiums and guarantee fees. Expenditures include funds disbursed on loans during the year, administrative expenses, and claims that result from the insurance and guarantee programs.

The direct loan program of the Export-Import Bank aims at increasing exports by providing loans at below-market interest rates to finance foreign purchases of U.S. products. Currently, Eximbank charges 10.75 percent on non-aircraft loans; in comparison, the private sector charges rates of 13.6 percent to 14.2 percent on comparable loans. 1/ The Eximbank subsidy equals the difference between the Eximbank interest rate and the market interest rate that exporters would otherwise pay. CBO estimates that the direct loan program involves an annual subsidy of between $200 million and $1 billion. 2/ U.S. exporters and foreign importers divide this subsidy. If exporters leave prices unchanged, foreigners obtain the entire benefit from the U.S. loan subsidy; if exporters raise their prices, they may recapture the gain received by the foreigner from the lower interest rate. 3/

The subsidy could be eliminated by increasing the interest rate charged on Eximbank loans to the market rate. Raising the interest rates on these loans to market rates would reduce the Export-Import Bank's budget impact while raising economic efficiency. For example, increasing interest rates on new direct loans

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1. Eurodollar loan and U.S. AAA corporate bond rates, December 1981.

2. Congressional Budget Office, "The Benefits and Costs of the Export-Import Bank Loan Subsidy Program" (June 1981).

3. At high employment there will be no net economic gain for the United States since some other U.S. economic activity must be curtailed to free resources for exports. Suppose a U.S. investment project must be given up. That forgone investment project would have earned at least the market rate of interest. In place of that investment project, however, the United States gains only the loan to finance the exports--bearing the below-market subsidized rate of interest.

to market interest rates would produce immediate savings of $2 million in 1983 and $342 million over the next five years (see Appendix A-150-c). (Savings accrue only on new loans since Eximbank cannot increase interest rates on previously committed loans.) The volume of direct loans would also decline, further contributing to a decrease in net outlays.

Eximbank also gives subsidies through loan guarantee programs, when guarantees are sold to U.S. banks at prices below their true market value. When Eximbank guarantees a loan made to finance an export, it creates a financial instrument that can serve as collateral for loans from other banks or from the Federal Reserve System. Interest rates for loans secured by such federally guaranteed collateral are among the lowest charged in the market. The potential profit to the underwriting bank and the exporter equals the difference between the market rate for commercial loans by importers and the rate at which the bank can borrow against the guaranteed loan. As mentioned above, commercial market rates in December 1981 varied between 13.6 percent and 14.2 percent, while comparable government borrowing rates were approximately 10.9 percent for 90-Day Treasury bills and 13.6 percent for five-year U.S. Treasury bonds.

The loan guarantee program aims at encouraging commercial banks to extend export credit loans by reducing the risk and uncertainty inherent in export credits. Proponents of federal loan guarantees point out that, if private commercial banks overestimate the risk of financing foreign transactions, they will supply too few such guarantees at a price that reflects their social value. When the government fills this gap by lending at market rates, it provides a volume of guarantees commensurate with their social value and raises economic efficiency. Charging such higher prices for the guarantee programs would reduce Eximbank's net outlays, the difference between Eximbank's expenditures and cash receipts, which include guarantee fees. Charging higher prices would still promote commercial bank credits that otherwise would have been unavailable because of market imperfections, thereby contributing to increased economic efficiency.

The Export-Import Bank is sometimes said to provide a conduit for foreign aid. The distribution of its loans among countries does not correspond, however, to the patterns of all other development assistance. In 1979, for instance, 75 percent of Eximbank loans went to Europe, East Asia, and Africa, representing 19 percent, 40 percent, and 16 percent of total lending, respectively. But when the Congress votes aid directly, the regional composition differs: the countries receiving 75 percent of Eximbank aid got only 25 percent of 1979 direct aid, while 75 percent of that year's direct aid consisted of economic assistance to Northeast Asia, South Asia, and Latin America. The Congress may intend these differences in aid distributions but, given oversight patterns, it seems more likely that the disparities reflect the secondary importance of the foreign aid function in Eximbank loans. If the goal is to transfer benefits to low-income countries, the Eximbank program is not an efficient mechanism for doing so.

The government could use Eximbank loans as a negotiating tool in its current international discussions aimed at further limiting export credit subsidization. If negotiations were successful, the subsidies involved in Eximbank lending would decrease over time. Such an outcome would presuppose close coordination between Eximbank lending and U.S. Treasury negotiations, as well as between Eximbank lending policies and other trade regulations, such as in anti-dumping legislation.

Domestic International Sales Corporations. Domestic International Sales Corporations promote exports by permitting a corporation to defer--in effect, indefinitely--payment of corporate income tax on part of its profit. As with other export subsidies, nonsubsidized U.S. citizens incur costs--through lost tax revenues--while U.S. exporters and foreign importers gain. When the gains accrue only to foreign importers, U.S. citizens as a group lose.

Eliminating the DISC program would bring significant increases in revenues. The Treasury estimates that as much as $1.3 billion in tax revenues were lost in 1980 from the DISC exemptions; CBO estimates that phasing out the DISC program would raise revenues by $0.9 billion in 1987 (see Appendix B-150-a).

Reassessing Individual Foreign Aid Programs in Terms of Current Policy Objectives and Economic Conditions

Total net outlays for foreign aid, including bilateral functional assistance, food aid, multilateral development banks, and the Economic Support Fund, amounted to $6.3 billion in 1981.

Measuring the benefits of foreign aid programs--which serve political and humanitarian ends--is more problematic than assessing export promotion programs, whose ends are measurable economic benefits. As a result, discussing how changes in foreign aid programs alter net economic benefits to the United States is more difficult. It is possible, however, to discuss the individual programs of the foreign aid function in terms of their consistency with current foreign policy objectives and current economic conditions. In particular, when circumstances have changed substantially since individual programs were initiated, the terms of these programs should be reassessed. Savings could be obtained by reducing programs that no longer achieve current policy objectives, either because economic conditions have changed or because policy objectives have changed. For programs that fit current policy objectives, savings might still be achieved by examining the degree of interest subsidy in the programs. For example, several foreign aid programs involve loans at fixed, below-market interest rates. The size of the interest subsidies has increased as market interest rates have increased, and the Congress could decide to change them. Moreover, it could restructure the subsidies to correspond to the different income levels of the recipient countries if this was considered consistent with foreign policy objectives. The amount of savings would depend on the extent to which the average interest rate on the loans was increased.

Public Law 480 Agricultural Commodity Sales. The Public Law 480 program was established in the 1950s to promote U.S. agricultural exports. Commodities are bought by the Commodity Credit Corporation, typically on the open market, and then provided to the recipient nation. Under Title I of the program, sales are financed through concessional loans; under Title II, grants are provided for humanitarian purposes; under Title III, Title I loans can be converted into grants. In 1981, net outlays for all three titles amounted to $1.3 billion, of which about 11 percent was provided as loans.

Much of the original justification for the Public Law 480 program has disappeared. The United States no longer has persistent large agricultural surpluses, and currency inconvertibility is less of a problem than in the 1950s. Because of these changed circumstances, some observers have called for ending the program. Opponents of the program also argue that in some countries Public Law 480 aid may have had a negative effect on agricultural development, thereby running counter to the objectives of the foreign aid program.

Advocates point out that the program has evolved into a flexible policy instrument that allows the Administration to shift aid quickly to different recipients as needs and policy objectives change. Commodities delivered under this program are commonly sold in urban markets in the recipient countries; recipient governments, therefore, treat the proceeds as general revenues.

A decision to reduce the size of Title I of the Public Law 480 program would depend on some determination of the extent to which the program contributes to current policy objectives, given that the original justifications for the program have disappeared (see Appendix A-150-b).

Alternatively, savings could be achieved by decreasing the overall level of loan subsidies under Title I, or by adjusting their level to the income levels of the recipient countries. Interest rates on these loans vary but they currently require a minimum 2 percent interest rate during a ten-year grace period, and 3 percent during a repayment period of up to 30 years. 4/ The subsidy element has increased over time as market interest rates have increased. Increasing interest rates on Title I loans to 8 percent would produce savings of $330 million over the next five years. This might, however, accelerate a trend in recent years to convert Public Law 480 loans into grants. For example, in 1981 approximately $0.1 billion of Title I loans were transformed into grants under Title III. Such shifts would decrease the savings from this change.

Economic Support Fund Loans. Unlike functional assistance, which is earmarked to finance specific projects, Economic Support Fund monies are not tied to particular programs. Loans accounted for about 12.5 percent of ESF's $2.2 billion obligations in 1981; grants constituted the rest. Some $950 million in new loans was disbursed, producing a cumulative balance of direct loans outstanding of $4.9 billion. Savings could be achieved by increasing the interest rate on all loans, or alternatively by raising the rate for higher-income recipients. Currently, the

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4. These minimum levels are set by Title 22, Section 2151t, of the U.S. Code Annotated.

interest rate charged is less than 3 percent. Most of these loans are provided to higher-income recipients.

As with the Public Law 480 program, the degree of subsidization has grown over time because market interest rates have increased while the rates charged on these loans have remained constant. At present, ESF loans bear a minimum 2 percent interest rate over a ten-year grace period, followed by 3 percent over a 30-year repayment period. The interest rate on federal long-term bonds at the program's inception was only 6.1 percent, compared with about 14 percent in January 1982. An increase in the interest rates charged would produce a savings in the form of increased interest receipts (see Appendix A-150-a). Increasing the interest rate on ESF loans to 8 percent would produce savings of $5 million in 1983 and $139 million over the next five years. Over time, the subsidy involved in these loans could be held constant by tying the rates charged to the market rate.

Multilateral Development Banks. In 1981, U.S. outlays for its membership in multilateral development banks--the World Bank, the Inter-American Development Bank, the Asian Development Bank,and the African Development Fund--totalled $1.0 billion. Just as the United States might adjust interest rates on bilateral loans according to the recipients' income levels, it might encourage the multilateral development banks to do likewise. Increased interest receipts, for a given distribution of loans, would decrease these banks' requirements for resources and, consequently, U.S. contributions.

The Generalized System of Preferences. As part of its foreign aid effort, the United States permits a large variety of exports by less-developed countries (LDCs) to enter the United States duty free. Revenue losses from this program might be reduced by ending the eligibility of relatively high-income LDCs for these concessions. Since the objective is to promote LDCs' export competitiveness, the preferences could be phased out as a country becomes more competitive.

Eliminating the eligibility of products from certain highly competitive LDCs, such as Taiwan, South Korea, Hong Kong, Brazil, and Mexico, would significantly reduce U.S. revenue losses. In 1980, these five countries accounted for $4.4 billion of U.S.

imports under a total GSP program of $7.3 billion. Subjecting these imports to applicable duties would have provided $244 million in additional revenues. 5/ Removing these countries' GSP eligibility would reduce the budget deficit by increasing revenues, although leaving expenditure levels unaffected. Such a policy change would, however, involve a cost to consumers in the form of higher prices.

CONCLUDING COMMENTS

Two strategies have been proposed through which the Congress could reduce outlays on international affairs. The first would narrow the scope of federal export promotion activities through the Export-Import Bank and Domestic International Sales Corporations. This would not only reduce budget outlays and tax expenditures, but would eliminate federal subsidies that produce few measurable economic benefits.

The second strategy would reassess existing foreign aid programs. Unlike export promotion programs, whose ends are measurable economic benefits, foreign aid programs aim at securing foreign policy objectives. Measuring success, therefore, in terms of net economic benefits is more problematic. It is possible, however, to discuss individual foreign aid programs in terms of current policy objectives and current economic conditions. In particular, where circumstances have changed substantially since individual programs were initiated, it may be time to reappraise their costs and benefits. In some cases, savings might be realized by modifying the programs to make their terms more consistent with current circumstances.

The first budget reduction strategy, reducing export promotion subsidies, promises the larger budget savings. In 1981, such programs accounted for almost 20 percent of the $11.1 billion total net outlays for the international affairs function. This does not include the tax expenditures involved in export promotion programs such as DISC. The second budget reduction strategy, decreasing the interest subsidies on foreign aid loans, would

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5. This estimate assumes an average tariff of 5.6 percent ad valorem, which is the average for U.S. manufactured imports when all the Tokyo Round reductions are taken into account.

produce savings, but if such subsidies were considered part of the desired total foreign aid supplied by the United States, decreased interest subsidies might be offset by increases in other foreign aid programs, cancelling any budget savings from the policy change.

CHAPTER V. NATURAL RESOURCES, ENERGY, AND SCIENCE

The federal budget functions for natural resources, energy, and science cover a wide variety of programs. The natural resources and environment function (300) contains two main categories of subfunctions: pollution control and abatement and development and protection of the nation's natural resources. The first category consists largely of the Environmental Protection Agency's (EPA) regulatory and enforcement activities and programs providing grants to states and localities for the construction of wastewater treatment facilities and regulation of pollution. Development of natural resources includes the Army Corps of Engineers construction programs for waterways and harbors, Department of Agriculture (USDA) land conservation and forestry programs, and Department of the Interior (DOI) national parks and programs for wilderness areas and federal rangeland management. The Department of Commerce's National Oceanic and Atmospheric Administration (NOAA) budget is also in this function.

The energy function (270) contains most of the Department of Energy's (DOE) programs, with the notable exception of its defense-related activities, such as the manufacture of nuclear weapons. Among the major programs included in the energy function are DOE energy research and development programs (R&D), regulation, the direct production of electrical power, and the Strategic Petroleum Reserve. The Department of the Interior and EPA also have small energy programs.

The general science and space function (250) includes most of the budgets for the National Aeronautics and Space Administration (NASA) and the National Science Foundation (NSF). DOE's general science programs are also in this function.

BUDGET HISTORY AND PROJECTIONS

Over the past decade, net federal outlays in the natural resources, science, and energy areas grew slightly more rapidly than the gross national product (GNP), rising from 0.8 percent ($8.6 billion) of GNP in 1970 to 1.0 percent ($30.3 billion) in 1981. But increasing concern with the size of federal expenditures has reversed this trend. CBO estimates that outlays for these functions will be $25.9 billion in 1982 and fall to $25.3 billion in 1983 if current policies continue. For the 1983-1987 period, total outlays are projected to be $131.9 billion.

Historical Trends, 1970-1981

The overall increase in expenditures since 1970 has been distributed unevenly among the three functions. Natural resources increased most, rising from $3.1 billion in net outlays in 1970 to $13.6 billion in 1981. Energy was second, increasing from $1.0 billion in 1970 to $10.3 billion in 1981. General science and space lagged, rising less than 50 percent during the decade, from $4.5 billion in 1970 to $6.4 billion in 1981. In 1970, the space and science budget received more than half of the money devoted to these areas, while energy and natural resources received 12 and 36 percent, respectively. By 1981, the space and science budget received only one-fifth of the total while energy and natural resources functions increased their shares to roughly 34 and 45 percent, respectively, demonstrating the shift in the relative importance of these functions over the decade.

The net outlays shown in Table V-1 document these shifts. The gross outlays were much higher, but were offset by government receipts from activities such as sales of irrigation water and electrical power. In 1981, offsetting receipts in the energy and natural resources functions totaled $2.6 billion.

Three principal factors caused the budgetary growth in these functions since 1970: increased environmental concerns, the energy crisis, and inflation. Passage of amendments to the Clean Water and Clean Air Acts in the early 1970s symbolized the shift in environmental considerations from the periphery to the center of public policy. Independently, the world price of oil began its dramatic rise and the Congress adopted measures to reduce U.S. vulnerability to oil disruptions. While each of these events affected public policy differently, they all resulted in more expenditures. But these new interests did not displace old ones; established programs also continued and grew more expensive as inflation and other pressures increased their costs.

Natural Resources. Several program areas contributed to the $10.5 billion growth in net outlays that occurred between 1970 and 1981 in the natural resources function (see Table V-1). In the pollution abatement subfunction, the largest single area of growth was the EPA wastewater treatment construction grants program,

TABLE V-1. FEDERAL OUTLAYS FOR NATURAL RESOURCES, ENERGY, AND SCIENCE (In billions of dollars)

Major Programs	Actual 1970	Actual 1981	Estimated 1982	Baseline Projection 1983	Baseline Projection 1987
Natural Resources					
Water resources	1.6	4.3	4.2	4.2	5.2
Conservation and land management	0.9	3.4	3.2	3.4	3.8
Recreational resources	0.4	1.6	1.5	1.4	1.4
Pollution control and abatement	0.4	5.2	5.3	5.0	4.3
Other natural resources	0.4	1.5	1.5	1.6	1.8
Pay raises a/	---	---	0.2	0.6	2.2
Deductions for offsetting receipts	-0.6	-2.5	-3.2	-3.5	-5.2
Net Subtotal, Natural Resources	3.1	13.6	12.8	12.6	13.6
Energy					
Energy supply	0.9	5.4	4.4	3.5	4.5
Energy conservation	0.0	0.7	0.7	0.5	0.5
Emergency preparedness b/	0.0	3.3	0.2	0.4	0.2
Energy information, policy, and regulation	0.1	1.0	1.0	1.0	1.1
Pay raises a/	---	---	0.1	0.2	0.4
Deductions for offsetting receipts	0.0	-0.1	-0.1	-0.1	-0.1
Net Subtotal, Energy	1.0	10.3	6.2	5.5	6.6
General Science and Space					
General science	0.9	1.5	1.6	1.6	2.0
Space flight	2.3	3.1	3.4	3.4	3.4
Space science	0.9	1.4	1.4	1.5	1.5
Pay raises a/	---	---	0.0	0.1	0.3
Other	0.4	0.4	0.5	0.6	1.2
Net Subtotal, General Science and Space	4.5	6.4	6.9	7.2	8.4
Net Total	8.6	30.3	25.9	25.3	28.6

NOTE: Details may not add to totals because of rounding.

a. See Table IV-1, footnote a, for distribution of pay raises. In this table, however, pay raises for 1982 are listed as a separate category.

b. Oil acquisition costs for the Strategic Petroleum Reserve are off-budget beginning in 1982, and therefore are not included in this table after 1981.

which had less than $200 million in outlays in 1970 but totaled $3.9 billion in 1981. In addition, other abatement, control, and compliance expenditures rose from about $200 million in 1970 to $1.3 billion in 1981. Expenditures by the Army Corps of Engineers for the development of water resources had the greatest outlay growth in the other natural resources subfunctions, rising from $1.[illegible] billion in 1970 to $3.2 billion in 1981. Land management and conservation programs increased from $900 million in 1970 to more than $3.4 billion in 1981. DOI recreational programs, such as those of the National Park Service, also experienced large outlay growth, rising from $370 million in 1970 to about $1.6 billion in 1981.

Energy. In the energy function, several different programs produced most of the $9.3 billion growth in net outlays between 1970 and 1981. The category of energy expenditures experiencing the largest increase was research, development, and demonstration, which grew by $3.5 billion over the decade to reach approximately $4.0 billion in 1981. Power marketing outlays by the Tennessee Valley Authority and similar agencies also increased substantially during this period, rising from $350 million to over $1.[illegible] billion in 1981. The Strategic Petroleum Reserve did not exist in 1970, yet in 1981 DOE spent approximately $3.3 billion to purchase and store oil. During this period, the costs of energy regulation and information also rose to nearly $970 million in 1981, up substantially from 1970 when such expenditures were only about $100 million.

Science. The general science and space function experienced growth of about $2.0 billion in outlays in the last decade. The largest single increase was in the space flight program--mainly because of the Space Shuttle--which increased by $800 million to $3.1 billion in 1981. The next largest increase occurred in the budget for the National Science Foundation, whose outlays doubled over the decade, reaching nearly $1.0 billion in 1981.

The 1982 Budget Decisions

Natural Resources. The Congress has cut funds for a number of natural resources and environmental programs. No funds for EPA construction grants have yet been appropriated for 1982, but the authorized ceiling has been reduced from $5.0 billion to $2.4 billion. Even if the entire $2.4 billion is appropriated, the 1982 funding level will be substantially less than appropriations in previous years, which were in the $3 to $4 billion range in

1979 and 1980. Of the 1981 original $3.3 billion funding level for EPA construction grants, more than half was rescinded, reducing the 1981 appropriation to $1.6 billion.

Funding for major Forest Service activities has been reduced from $1.7 billion in 1981 to $1.4 billion in 1982, while appropriations for water resources development have been decreased from $4.1 billion to $3.9 billion for these years. Budget authority for recreational resources programs, primarily those of the Department of the Interior, has also been cut, from $1.6 billion in 1981 to $1.5 billion in 1982. These areas were subject to authorization ceilings enacted under reconciliation. In addition, over $200 million in 1981 funds for other natural resources programs, primarily park acquisition, was rescinded.

Energy. The Congress has also enacted significant cuts for 1982 in a number of major energy programs, setting authorization levels for 1982 through 1984 below 1981 appropriation levels. The 1982 appropriations for all nonmilitary energy programs are also below 1981 levels, even with the increased funding for the Strategic Petroleum Reserve (SPR). Excluding SPR expenditures and adjusting for the deferrals of $560 million in 1981 appropriations for conservation programs and fossil energy research, outlays for nonmilitary DOE activities were reduced from $5.5 billion in 1981 to $5.0 billion in 1982. The major reductions from 1981 occurred in conservation programs ($0.2 billion, a 40 percent decrease), fossil energy programs ($0.15 billion, a 20 percent decrease), and regulation ($0.1 billion, a 54 percent decrease).

Science. The NASA space flight program was an exception to the widespread cuts in these functions. The 1982 appropriation of $3.5 billion is up from the $3.2 billion provided in 1981.

Baseline Projections, 1983-1987

Under the baseline projections for these three functions, net on-budget outlays will fall slightly, from $25.9 billion in 1982 to $25.3 billion in 1983, because of the budgetary changes made by the 97th Congress. Although outlays are then projected to rise, reaching $28.6 billion in 1987, they will remain below the 1981 outlays of $30.3 billion during this entire period. (This on-budget reduction is more than offset by off-budget Strategic Petroleum Reserve outlays.)

If current policy remains in effect, the 1983 relative shares of total net outlays are projected to shift from natural resources and energy toward general science. In 1983, natural resources and energy outlays are projected to decline to $12.6 billion and $5.5 billion, respectively. By contrast, general science outlays are projected to rise to $7.2 billion in 1983.

During the 1983-1987 period, the baseline projections show that natural resources' share will decline relative to both those of energy and science. The natural resources budget is projected to rise by only $1 billion, to $13.6 billion in 1987, primarily due to declining outlays for EPA construction grants and steadily increasing receipts from timber sales and mineral leasing. In contrast, the energy budget grows by $1.1 billion to $6.6 billion by 1987, while the science budget increases by $1.2 billion to $8.4 billion. Since the natural resources budget was larger at the start of the projection period, the smaller rise entails a larger than proportional decrease in budget share.

BUDGET STRATEGIES

This section presents four nonexclusive strategies for reducing the net federal budget through changes in the natural resources, energy, and science functions. The first two strategies focus on reducing expenditures, while the last two are concerned with increasing offsetting receipts and revenues. The strategies are:

- Concentrating federal R&D programs on basic research and reduce commercialization efforts;
- Changing the federal/state division of responsibilities and revenues;
- Recovering the costs of government services; and
- Obtaining market value for federal resources.

Concentrating on Basic Research and Reducing Commercialization Efforts

This budget strategy applies primarily to the energy function, although it could be relevant elsewhere as well. The federal government supports all levels of research on new energy technologies, from the most basic research to programs designed to demonstrate the commercial viability of particular applications ("commercialization"). The major programs are nuclear fission, including the breeder reactor; magnetic fusion; fossil fuel; conservation; and solar and other renewable resources. While federal aid for basic research has existed for years, government support of commercialization efforts, apart from nuclear energy, is relatively new and is largely a result of the energy crisis. This support has caused marked increases in the energy budget.

A precise estimate of the relative shares of basic research and commercialization would require a project-by-project evaluation. Nevertheless, an outer-bound estimate for commercialization can be made by comparing the budgets for specific technologies with those for general science. In 1981, DOE spent nearly $4.0 billion on commercialization and research on technologies with at least some near-term potential. (These include the programs for nuclear fission, fossil fuel, conservation, breeder reactor, solar, and other renewable resources.) In contrast, only $1.1 billion was spent in 1981 on general science research or research into areas with no near-term applications, such as magnetic fusion. This rough estimate only defines the furthest limit of what might be considered technology commercialization. In addition, the Synthetic Fuels Corporation (SFC) and the Clinch River Breeder Reactor programs could increase commercialization outlays substantially, especially if the SFC grants direct loans and enters joint ventures and purchase agreements, as it is authorized to do. 1/ In sum, it is probable that commercialization outlays will increase even more in the future relative to basic research outlays.

The government generally has focused its commercialization efforts on publicly desirable technologies that the private market could not develop rapidly. For example, there are costs other than price associated with a high level of oil imports--primarily economic insecurity from potential disruptions and foreign policy constraints. Therefore, it is in the public interest to bring import-saving technologies into commercial use faster than private

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1. The Congress has appropriated $17.4 billion for the Synthetic Fuels Corporation (SFC) and to foster other alternative fuels development programs. While the amount of outlays this appropriation will eventually generate is unknown, it does indicate the level of financial exposure of the federal government.

markets would. Similar arguments might be constructed for government support of other commercialization programs.

Independent of the rationale for early commercial development of various technologies, some thought should be given to the effectiveness of past federal commercialization programs. Case studies have shown that government support, however well-motivated, has not been a strong factor in achieving early commercial development of the sponsored technologies, except when the government itself needed the technology. For example, federal sponsorship of commercial nuclear-powered ships, such as the U.S.S. Savannah, induced very little private use of such ships. Similarly, the supersonic transport (SST), which the federal government supported for years, was not greeted with enthusiasm, or financial commitment, by the airline industry. Indeed, France and the United Kingdom are considering ending their support of the SST. The successful federal promotion of new technologies, most notably semiconductors and synthetic rubber, occurred when the government wanted the technology for its own use, not just for the general good. 2/

Given these relative strengths and weaknesses, the government might increase its contribution to technological development by concentrating on basic research, in which it has a comparative advantage, and decreasing commercialization activity, in which it is relatively weak. While technically competent to judge products and processes, government planners are not subject to the price disciplines that face corporate planners. Without price discipline, the government could continue to back technically practical, but commercially unfeasible, technologies well beyond the limits of benefits to society. Conversely, government planners can wait for research to produce results, because they do not face the short-term economic strictures of private companies. In addition, while firms are principally interested in those returns to research and development that accrue to the firm, the government is interested in the returns to society as a whole and so can place a higher value on the benefits of research investments.

Synthetic Fuels Corporation. At issue in this strategy is the value of each government commercialization program relative to

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2. For more information on these case studies, see Walter Baer and others, Analysis of Federally Funded Demonstration Projects: Supporting Case Studies, (Santa Monica, California: Rand Corporation, 1976).

the value of the budget savings achieved by its cancellation. The Synthetic Fuels Corporation (SFC) (see Appendix A-270-e) and other synthetic fuels development programs are probably best viewed in this context. The Congress established the SFC as an off-budget entity in 1980 and appropriated $12.2 billion to provide loan and price guarantees and purchase agreements to qualifying projects. The SFC was also given authority to make direct loans or participate in joint ventures, if the first three measures should prove insufficient. For the transition period during the establishment of the SFC, the Congress also provided DOE with $5.2 billion for support of synthetic fuels projects near commercial readiness.

The incentives for private firms to develop synthetic fuels were conceived at a time when oil demand seemed unresponsive to price, oil imports were at an all-time high, and domestic oil prices were controlled. Since then, the higher price of oil resulting from decontrol has provided the energy industry with both the capital and the financial motivation to develop alternative sources for liquid fuels. In addition, the general decline in oil demand, especially for gasoline, and the recent significant drop in oil imports indicate that more oil conservation is possible than previously expected. These trends lessen the near-term need for synthetic liquid fuels and may allow the private sector enough time for an efficient, deliberate development program. The SFC and other synthetic fuel development programs, therefore, could be significantly reduced or even terminated. If the SFC were eliminated, the budget savings could be $34 million in 1983. Over the 1983-1987 period, the budget savings would be $186 million. Although most of these projected savings would come from the elimination of administrative costs, the government would also significantly reduce its financial exposure, which potentially could be much greater if some projects financed by the $12.2 billion SFC appropriation were to fail. The risk is that current conditions in the oil market may prove transitory, again heightening the need for alternative liquid fuels.

Clinch River Breeder Reactor. Other commercialization efforts may be premature. The Clinch River Breeder Reactor (see Appendix A-270-b) is being developed at a time when projections of uranium supply and demand indicate that a breeder may not be economic until well into the next century. While possible uranium shortages in the distant future may warrant research into breeder reactor alternatives, which DOE is pursuing apart from Clinch River, these conditions do not require near-term commercialization efforts. In addition, the cost of the project has escalated significantly. Although the original projected cost was $700 million, more than $900 million has already been spent. Current estimates suggest that the project will take another $1.7 billion to complete, for a total federal investment of about $2.6 billion. Furthermore, French breeder technology is said to be more advanced, and the United States might be able to purchase it directly from France without the expense of developing it independently. Terminating the Clinch River Breeder Reactor would save $200 million in 1983 and a total of $1.1 billion between 1983 and 1987.

The Congress could decide that commercial development of new technologies should be left to the private sector, which ultimately will decide whether or not to use them. If it chose to end all federal commercialization support and concentrate on basic research, additional reductions in the federal budget would result. Pursuing this strategy, however, would risk that present savings might come at the cost of future benefits. Withdrawal of federal support from projects that have near-term potential would place more of the burden on the private sector, which might choose not to develop as many technologies or to develop them less rapidly.

Changing the Federal/State Division of Responsibilities and Revenues

In the 1970s, concern for the deteriorating environment spurred the federal government to increase its aid to state and local governments to deal with environmental problems. Simultaneously, it changed the division of revenues from the sale of resources on federal lands in favor of the states. Whereas the federal government, which bears most of the costs, previously received most of the revenues, now state and federal gross shares are equal. Two ways to reduce net budgetary costs are: decrease federal expenditures by increasing state and local governments' financial responsibility for those environmental projects of direct benefit to them, and increase the federal share of receipts from the sale of federal resources.

Greater State and Local Responsibility. When the federal government imposed stricter environmental regulations during the 1970s, it also provided financial assistance to help the state and local governments meet these heightened standards. Thus federal aid rose to meet a broad range of environmental goals. EPA's construction grants program for wastewater treatment plants, which totaled $3.9 billion in 1981 outlays, was the largest of these aid programs (see Appendix A-300-e). The EPA also provides grants to states and localities to enforce environmental regulations, such as those required by the Clean Water and Clean Air Acts. The DOI also provides grants to states and counties for environmental purposes.

While federal aid generally has encouraged states and localities to undertake more responsibilities, federal assumption of a major part of the costs may have led to inefficiencies that could be redressed by transferring some costs to state and local governments. For example, since EPA currently pays 75 percent of allowable construction costs for wastewater treatment plants, but no operating costs, this grant system could have encouraged the construction of capital-intensive and overly sophisticated, but poorly maintained, plants.

In December 1981, the Congress enacted program changes that reduced the federal share of construction costs to 55 percent beginning in 1985. While this change may encourage more efficient use of federal funds, further savings are possible. First, the federal share could be reduced to 45 percent, with corresponding reductions in budget authority. Second, the $200 million annual authorization for combined sewer overflows into marine bays and estuaries, which begins in 1983, could be eliminated, as could the funds for major rehabilitation of sewers, new collector sewers, and combined sewer overflow. Third, the current two-year time limit on the states' obligation of the funds could be ended. The time limit has the potential to encourage premature and inefficient contracting by local authorities to avoid losing their grants at the end of the two-year period. Given the present level of unexpended appropriations and the slow spendout rate, large near-term savings in outlays are not likely. If the above program and corresponding funding changes were instituted, little, if any, money could be saved in 1983, but over the 1983-1987 period, $820 million could be saved.

Such shifts in responsibility, however, should be carefully evaluated since these funds are the principal lever the federal government has to enlist the cooperation of the states to meet environmental goals. Should the funds be cut significantly, some states and localities might reduce their environmental efforts, with the consequent loss of much progress.

Increase the Federal Share of Revenues from Sale of Federal Resources. In addition to shifting the responsibility for some expenditures to state and local governments, the federal government could retain a larger share of receipts derived from onshore federal resources that it currently divides with the states and counties (see Appendix A-300-c). Since passage of the Coal Leasing Amendments Act of 1975, gross revenues for most federal mineral resources have been split equally between the states and the federal government. (Prior to the 1975 act, the state share was 37.5 percent and the federal share was 62.5 percent.) The net federal share may be much lower, however, since royalty and other resource payments are deductible from federal taxes as business expenses. Other federal land programs, such as leasing grazing rights (see Appendix A-300-b), also have sharing rules. Total receipts from onshore federal lands leasing and fees in 1981 were over $750 million. In 1981, payments to the states resulting from these receipts totaled $350 million. (By contrast, the $10.1 billion derived from offshore leases in 1981 accrued entirely to the federal government.) Changing the federal/state share of mineral leasing gross receipts to the pre-1975 ratio (62.5 percent for the federal government and 37.5 percent for the states) would net the federal government $146 million in 1983 and $879 million during the 1983-1987 period. (This shift in the gross shares is roughly equivalent to an even division of net, after tax, receipts.)

Although the benefits of federal land use are shared with the states, the costs of maintenance, preparation for leasing, enforcement, and reclamation are borne by federal agencies. The rationale for this is that federal ownership preempts private use and taxation by the states. In addition, development of these resources increases demand for local services, such as schools and roads.

Recovering Costs of Government Services

When the federal government provides services that clearly benefit particular and identifiable groups or individuals, it might be appropriate to charge user fees for these services. Often, the government provides unique services for which there are no private-sector markets. In the absence of a market to guide the appropriate pricing of the services, the government could at least attempt to recover its costs. If user fees do not cover the costs, the undercharge tends to distort the allocation of resources, resulting in over or wasteful use of federal resources. It also requires that the service be subsidized by others who do not use the service.

Federal Recreational Areas. Entrance fees at federal recreation areas do not cover the costs of maintaining recreational facilities (see Appendix A-300-d). Besides providing a subsidy to those who use the areas, the low fees probably contribute to overcrowding and, possibly, abuse of the areas. At areas charging fees, visitors pay an average of 20 cents per visit. Because only some areas charge fees, however, all visitors to all federal recreational areas pay only 1 cent per visit when receipts are averaged over all sites. In some instances, charging fees is impractical, either because the areas are too remote or because access to them is uncontrollable. In other federal recreation areas, such as water impoundments and traditional national parks, the fees are often already collected and could easily be raised to an average of 60 cents a visitor above the cost of collection. If this were done, federal receipts would rise by $30 million in 1983 and by $381 million over the 1983-1987 period.

Strategic Petroleum Reserve. The Strategic Petroleum Reserve (SPR) is another instance of the government providing a service--in this case, insurance against another oil import curtailment--without recovering the costs of the service (see Appendix B-270-f). Although the Congress placed this program, which costs $2 to $4 billion annually, off-budget for 1982, the impact on the economy remains the same as if it were on-budget. By imposing a tax or fee on the direct users of oil--the primary beneficiaries of the SPR--the costs of this insurance would be decreased for those who are less direct beneficiaries. A tax or fee could take three forms: an import fee on crude oil and refined products; a gasoline tax; or a fee on crude oil used by U.S. refiners, with an equivalent tax on imported refined products. Since the size of the fee or tax necessary to pay for the SPR would be less than $1 per barrel, or 3 cents per gallon for a gasoline tax, the impact on consumer prices would not be large. Similarly, the effects on the automobile industry should not be significant. A tax of 50 cents per barrel on domestic and imported refined products would raise federal revenues by $2.9 billion in 1983 and $14.5 billion during the 1983-1987 period. The SPR program would cost about this amount during the period.

Subsidies for Electricity Generation. Users of electricity in general and nuclear-generated electricity in particular benefit from several different government services for which fees do not cover government costs. Undercharges occur in nuclear waste disposal and uranium fuel enrichment programs and in subsidized low-interest loans for some utilities.

Disposal of Nuclear Waste. The federal government spends over $200 million annually on research to determine the best means and places to dispose of spent fuel from commercial nuclear reactors (see Appendix A-270-c). While the consumers of electricity from these reactors are the primary beneficiaries of this research, they now pay none of its costs directly. Producers and users of this electricity might make more economic decisions if they faced the true cost of the nuclear-generated electricity and paid the disposal research costs. Imposing a surcharge of about one-half mill per kilowatt hour on nuclear-generated electricity would provide enough funds in the near term for the nuclear waste R&D activities. This action would increase the average consumer's price of electricity by less than 1 percent, while providing the federal government $225 million in 1983 and $1.4 billion during 1983-1987.

Uranium Enrichment. Another implicit subsidy to the nuclear-power industry is the undercharge for uranium enrichment at federal facilities (see Appendix A-270-d). Whereas federal fees to increase the U-235 fraction in nuclear fuel are set to recover only incurred costs, private firms routinely cover the costs of taxes, insurance, and return on equity in their prices. If enrichment service fees were raised to eliminate these undercharges, government rates would rise by 17 percent. Additional revenues would total $525 million during 1983 and $3.2 billion for 1983-1987.

Rural Electrification Administration. Certain electric power and telephone utilities, such as those financed by the Rural Electrification Administration (REA), are another instance in which the government does not recover the full cost of the services it provides. These power authorities receive substantial direct interest subsidies through REA's direct loan program and implicit subsidies through REA-guaranteed direct loans from the Federal Financing Bank. These subsidies may encourage the construction of excess capacity and represent a significant contingent liability of the federal government.

One possible approach to reduce the federal cost of REA programs would be to reduce interest subsidies on direct loans and to lower loan guarantee authority to a level that would encourage a more efficient allocation of scarce federal credit assistance. If interest rates for direct loans were set at 3 percentage points below the cost of federal borrowing and loan guarantee authority was reduced by 50 percent, the federal government would save $300 million in off-budget outlays in 1983 and $7 billion between 1983 and 1987 (see Appendix A-270-f).

Although increased charges are desirable for budgetary, efficiency, and, perhaps, equity purposes, two potential difficulties arise from the higher prices they entail. First, these increased prices could be reflected in a slight increase in inflation. Second, a shift in the financing of government services from general revenues to cost-covering devices, such as user fees or higher rates or prices, could impose hardships on some recipients because they are poor, dependent on the service for employment, or have made investments that would be worth less if federal support declined. These hardships could be suffered by individuals, firms, localities, or regions.

Obtaining Market Value for Federal Resources

The preceding section discussed instances in which the government received less than it cost to provide services and suggested a strategy of full cost recovery. This section discusses a strategy of market pricing for certain federal resources.

In areas with private markets, prices for federal resources could be set through use of competitive bidding. This would result in efficient use of government resources and significant increases in government revenues.

Federal Irrigation Programs. In many cases, federal fees do not begin to match the market value of the good or service provided. Such an undercharge can distort the allocation of resources and cause abuse and overuse of resources under federal purview. For example, subsidized water for irrigation was originally provided to encourage development of the West (see Appendix A-300-a). Thus, federal water projects did not attempt to sell irrigation water at market rates, but rather based on what farmers could afford. Currently, however, low water rates may encourage wasteful use of water in regions that no longer need subsidized development. For example, California farmers receiving federal water are growing low-value crops like cotton and rice, which would better be grown in regions that have a comparative advantage in those crops. The cotton also receives federal price supports because excess supply drives down prices. In this case, misallocation of federal funds in one area also encourages misallocation of federal funds in other areas. Raising water fees to cover costs (roughly $50 per acre-foot) would save $22 million in

1983 and $375 million over the next five years. Raising them to market levels (roughly $100 per acre-foot) would provide net receipts of as much as $800 million over the same period.

Grazing Rights on Federal Lands. The policy on pricing of federal resources varies from agency to agency. Fees for grazing livestock on federal rangeland are a case in point (see Appendix A-300-b). Two agencies, the Department of Defense (DoD) and the Bureau of Indian Affairs (BIA), receive market values for their grazing rights by auctioning them. However, the agencies with the largest landholdings--the Forest Service and the Bureau of Land Management--allocate grazing rights by permit and collect fees based on beef cattle prices, forage values, and other costs associated with raising cattle. These grazing fees ($2.30 per animal unit month in 1981) have rarely been as high as nearby commercial rates ($5 to $12 per animal unit month) or comparable bids for grazing on DoD or BIA land. Furthermore, possession of a grazing permit, which is obtained by federal administrative process, is usually of substantial economic value to the holder. Competing ranchers, not so favored, must pay market rates and are at a comparative disadvantage. If permits were auctioned, with the required minimum bid equal to the current fee, the public would receive this difference in value between market rates and the current grazing fees. Such a policy could collect as much as $3 million in extra receipts in 1983 and $87 million over the next five years.

On the other hand, charging market rates for identifiable beneficiaries of federal projects might cause hardships for some individuals, classes of individuals, and regions or localities. In addition, the historic enfranchisement of individuals should be considered. If recipients were assured of continued federal support for certain projects, they may have taken actions and made investments that would be worth less if federal support declined. Therefore, changing commitments in midstream might, in effect, be asking these individuals to bear the costs of a national good. Moreover, the key disadvantage in adoption of market pricing in these programs is that the primary burden of each change would be felt in the West; thus the cumulative burden of these changes on this area of the country would probably be large.

CONCLUDING COMMENTS

The four major budget strategies outlined in this chapter are: concentrating federal R&D programs on basic research, while reducing commercialization; changing the federal/state division of responsibilities and revenues; recovering the costs of government services; and obtaining full-market value for federal resources.

Of the four strategies, the third (recovering the costs of government services) would probably most reduce the net federal budget. Charging fees to cover the cost of federal services could increase federal revenues significantly. For example, if petroleum users paid for the construction and filling of the Strategic Petroleum Reserve, this alone would raise $2.9 billion annually.

The first strategy (reducing commercialization efforts) would rank second in reducing the net federal budget and would be the easiest to implement. Federal commercialization efforts in 1981 may have been nearly $4.0 billion. The expenditure reductions, however, are accompanied by the risk that present savings might come at the cost of future benefits.

Changing the federal/state division of costs and revenues would probably not produce very large outlay reductions in the immediate future. The largest program in this area in 1982, the EPA construction grants, has already been cut significantly. Other federal payments to states for programs in these functions were less than $1 billion in 1981. Therefore, this strategy is unlikely to produce significant reductions in net federal outlays.

Obtaining full value for federal resources would not immediately result in significantly larger receipts. Most changes in these procedures, such as charging market rates for federally provided water as new contracts are negotiated, could take years to show sizable results. In addition, most of the impact of these changes would be felt in one region of the country, the West.

CHAPTER VI. AGRICULTURE

The agriculture budget function (350) covers two groups of federal activities. One is the support and stabilization of farm prices and incomes. The other includes agricultural research and the provision of services such as extension education, credit, market intelligence, commodity grading and inspection, and animal and plant pest and disease control. Outlays in the farm income stabilization subfunction were $4.0 billion in fiscal year 1981, while outlays in the agricultural research and services subfunction were $1.6 billion.

BUDGET HISTORY AND PROJECTIONS

Total agriculture outlays are about 1 percent of all federal expenditures. In real terms, after adjusting for inflation, they declined by about half from 1970 to 1981. About two-thirds of the outlays are accounted for by commodity programs to stabilize prices and incomes; a change in policy toward a greater dependence on markets helped to reduce these costs in the 1970s. In 1981, the Agriculture and Food Act (Public Law 97-98) essentially continued the commodity programs for the 1982-1985 crops, while the reconciliation act had a relatively small effect on agriculture outlays. If current policy were to be maintained in 1983-1987, agriculture outlays would decline in real terms.

Historical Trends, 1970-1981

Agriculture outlays are far more variable from year to year than outlays in most other budget functions. This reflects the volatility of farm production and prices. In 1974, for example, agriculture outlays declined from the level of the previous year by about one-half, whereas in 1977 they more than doubled. In 1982, they are expected to be more than double the level of 1981.

Commodity programs account for more than three-fourths of the outlays in the farm income stabilization subfunction; other principal programs in this subfunction are federal crop insurance and Farmers Home Administration (FmHA) loans to farmers (see Table VI-1). Under the federal crop insurance program farmers can buy in-

TABLE VI-1. FEDERAL OUTLAYS FOR AGRICULTURE
(In millions of dollars)

Major Programs	Actual		Estimated	Baseline Projection	
	1970	1981	1982	1983	1987
Farm Income Stabilization					
Commodity programs					
Major crops a/	3,004	1,457	8,005	2,225	1,475
Dairy	87	1,894	1,907	1,867	1,706
Peanuts	35	28	75	50	24
Tobacco	115	-51 b/	-82 b/	25	21
Other	536	666	1,288	1,284	1,255
Subtotal, Commodity Programs	3,777	3,994	11,193	5,451	4,481
Federal crop insurance	21	2	170	202	443
Other	791	22	1,066	997	1,197
Subtotal, Stabilization	4,589	4,018	12,429	6,650	6,121
Agricultural Research and Services	577	1,584	1,504	1,607	1,906
Pay Raises c/	---	---	---	52	301
Total	5,166	5,602	13,933	8,309	8,328

a. Wheat, feed grains, rice, soybeans, and upland cotton.

b. Minus sign denotes receipts in excess of outlays.

c. See Table IV-1, footnote a, for distribution of pay raises.

surance against crop losses caused by natural hazards; the premiums are subsidized by the government. Agricultural commodity programs undertake to support and stabilize farm prices and incomes by means of several measures, including price supports, direct payments, and supply controls:

- Price supports are used to maintain the minimum prices of agricultural commodities at levels approved by the Congress. The government supports prices through commodity loans to farmers or by purchasing commodities.
- Direct payments are made to producers of wheat, feed grains, rice, cotton, and wool and mohair to supplement their incomes in low price years. For farmers raising these crops, the direct payments are called deficiency payments. Payments are also made to farmers who agree to reduce the acreage of certain crops. Direct payments for income support and disaster losses averaged about three-fifths of commodity program outlays in the 1970s. Since 1975, however, income support payments have been made less frequently and in smaller amounts.
- Several tools are used to influence the supply of farm products, including acreage allotments, marketing quotas, cropland set-asides, acreage diversion, and farmer-owned grain reserves.

A decline occurred in real commodity program outlays in the years 1970-1981, reflecting changes in commodity policy for wheat, feed grains, rice, and upland cotton. As farmers increased their sales to foreign markets, and as farm output and incomes grew, the federal government moved away from a heavy involvement in support programs for these commodities and toward greater reliance on markets. In contrast, the policy for milk, tobacco, and peanuts remained essentially unchanged. High milk price supports in recent years have enhanced dairy farmers' incomes at the expense of taxpayers and consumers. Outlays for the purchase of surplus dairy products were $1.9 billion in 1981--about 50 percent of commodity program outlays.

Outlays for agricultural research and services increased about 1 percent per year in real terms from 1970 to 1981. Most of the outlays were for research, extension education, and animal and plant protection programs:

- Funded research is principally scientific research in animal and plant production, natural resource use, and processing, storage, and distribution of agricultural commodities. Research outlays were about $615 million in 1981. Approximately 25 percent of research outlays are allocated to the states by formula.

- Extension education outlays were about $300 million in 1981. About two-thirds of these outlays are allocated by formula to the states.

- Outlays for the control of animal and plant pests and diseases were about $280 million in 1981.

The 1982 Budget Decisions

The reconciliation act of 1981 affected several agricultural programs, although it reduced net outlays only slightly. Reconciliation tended to reduce the government's influence in the farm economy and to shift the costs of programs to the private sector. As of October 1, 1981, the minimum level of dairy price support was reduced from 80 percent of parity to 75 percent. 1/ The program providing loans for on-farm storage facilities was made discretionary and its availability was assured only in areas lacking adequate storage capacity. Interest rates on farm ownership and operating loans for farmers with limited resources were raised moderately. For 1982, the ownership loan level was reduced from the 1981 level, and the operating loan level was increased. For emergency disaster loans, the amount of loss needed to qualify was raised, as was the interest rate on the loans. Finally, user fees were adopted for federal commodity and warehouse inspection services.

Another important development was the Agriculture and Food Act of 1981, which essentially extended current agricultural commodity programs. It continued deficiency payments for wheat, feed grains, upland cotton, and rice, and income support payments for wool and mohair. However, it authorized disaster payments only in counties where federal crop insurance is not available, essentially

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1. The parity price of milk is the price, in current dollars, that gives milk the same purchasing power per unit in terms of goods and services bought by farmers and their families as prevailed in the base period, January 1910 to December 1914.

eliminating these payments after 1982. It continued price supports through commodity loans and government purchases and extended the farmer-owned grain reserve. The dairy price support program was unchanged in form, although the minimum level of price support was reduced as compared with permanent authorizing legislation. The peanut program was made less restrictive as to who could grow peanuts. A sugar price support loan program was authorized that raises domestic sugar prices substantially above current world prices.

A large increase in 1982 expenditures was caused mainly by high commodity program outlays resulting from low prices for 1981 crops. The fall in prices reflected record or near-record domestic production, generally good harvests abroad, and weak economic growth here and abroad. Deficiency payments account for about a fifth of the 1982 outlay increase for major crops, but commodity loans and farmer-owned grain reserve loans make up the largest share of the increase. The loan repayments will show up as budget receipts in subsequent years.

Baseline Projections, 1983-1987

Agriculture outlays under current policies are projected to total $8.3 billion in 1983 and 1987. For the five-year period, total commodity program outlays average about $5.0 billion annually, and dairy price support outlays about $1.8 billion. Deficiency payments are projected to diminish in relative importance and disaster payments are not projected after 1982. Expansion of the federal crop insurance program increases the relative importance of premium subsidies and administrative expenses in total outlays. For the outyears, the largest share of farm income stabilization outlays is taken up by commodity loans and purchases, farmer-owned grain reserve storage payments, interest, and crop insurance premium subsidies. Agricultural research and services outlays increase from $1.6 billion in 1983 to $1.9 billion in 1987, declining after adjusting for inflation.

BUDGET STRATEGIES

This section examines two avenues for reducing federal outlays on agriculture. One would be to place more reliance on markets in determining farm prices and incomes--continuing the trend of agricultural commodity policy in recent years. Another approach would be to shift certain federal expenditures for agricultural research and services to state or local governments and to private groups.

Increasing Reliance on Markets in Determining Farm Prices and Incomes

The major long-standing federal concern in agriculture has been with assuring adequate supplies of agricultural products. Since the 1930s, this concern has been reflected in programs to stabilize farm prices and to enhance farm incomes. A principal means of doing this has been commodity programs that transfer risk and uncertainty in farming to the public sector. In the early 1960s, public dissatisfaction with the high costs of commodity programs for grains and upland cotton motivated the development of a long-term strategy that allowed the gradual reduction of grain and upland cotton price supports to world price levels. Direct payments were made to farmers to cushion this transition and to encourage them to participate in voluntary supply control programs. In the 1970s, agricultural policy for these commodities continued to evolve toward a greater market orientation, focusing more on stabilization and less on income support. Commodity programs diminished sharply in importance for these crop farmers. By the late 1970s, the average level of federal support in grainsand upland cotton was about $0.20 per $1.00 of crop cash receipts, as compared with nearly $1.00 per $1.00 of cash receipts in the early 1960s.

In contrast, the policy for milk, peanuts, and tobacco has changed little since the 1930s, and the government continues to exert a strong influence on supplies and prices for these commodities. Tobacco and peanut prices are supported through acreage allotments and marketing quotas in combination with commodity loans made to farmers. Milk prices are supported through government purchases of dairy products. For these commodities, price supports are used both to stabilize prices and to enhance incomes.

The justifications for the federal commodity programs conceived in the 1930s--chronic excess production capacity, substandard farm incomes, and low returns to farm production resources--no longer exist. Farmers still face the challenges of risk and uncertainty--indeed, these are inherent in agriculture. And the growing dependence on export markets creates new sources of risk and uncertainty that did not loom very large when the commodity programs were first conceived.

Reduce Dairy Price Support Outlays. The federal government supports the price of milk by purchasing manufactured dairy products. The dairy price support program has increased farm milk prices at the expense of consumers and taxpayers, but it has also helped to stabilize the dairy industry, resulting in an assured supply of milk and dairy products. In the past two years, however, high milk price supports have contributed to a sharp expansion in milk production. In 1981, the commercial milk supply exceeded commercial use by about 10 percent, and the federal government purchased the excess at a cost of almost $2 billion. The government inventory of cheese, butter, and nonfat dry milk is nearly three times as large as commercial stocks.

Under the Agriculture and Food Act of 1981, the Secretary of Agriculture must increase the level of milk price support at the beginning of each marketing year (October 1) for the 1982 through 1984 marketing years. The act sets a minimum level of $13.25, $14.00, and $14.60 per hundredweight of milk, respectively, for each of these marketing years; these levels are slightly less than 70 percent of parity. Under certain conditions, the minimum level of support rises to 70 or 75 percent of parity.

Clearly, there is a serious imbalance between milk supply and demand. Furthermore, it is unlikely that a balance will soon be restored. Consumption cannot be expected to increase by much more than 1-2 percent annually over the long term. On the other hand, milk production is projected to increase, so that there is little prospect of commercial milk supply coming in line with consumption by 1986. Government purchases are expected to remain high relative to milk production, exceeding those needed to provide reasonable stability in prices and supplies. Therefore, dairy price support outlays are projected to average $1.8 billion during the next several years.

The Congress could act to reduce dairy price support outlays and restore milk supply and demand balance. To achieve this objective, the Congress could enact legislation that would reduce the current level of milk price support by 15 percent over four six-month intervals beginning April 1, 1982 (see Appendix A-350-b).

A phased reduction in the level of milk price support would be a clear signal to dairy farmers that the federal government intended to restore supply and demand balance to the industry. This approach would allow an orderly adjustment process and perhaps avoid a more disruptive adjustment in the future. On the one hand it would act to reduce milk prices and milk production, and on the other it would promote increased consumption of milk and dairy products. Annual average milk production in 1983-1985 would decline from the level under current policy by 5 percent. Consumer prices would average 8 percent lower, and consumption would average 1 percent more per year. With reduced production and increased consumption, government purchases could decline. Consequently, dairy price support outlays would average $1.3 billion less per year in 1983-1985.

While a reduction in the level of milk price support would reduce dairy price support program outlays, dairy farmers' annual average cash receipts in 1983-1985 would decline about 20 percent from the level under current policy. Some dairy farmers would be hard pressed to stay in operation because of lower incomes. This option might lead to more volatile supplies and prices, since milk supply and commercial demand would be in close balance by 1986; there is evidence of greater price volatility when government purchases are less than 2 percent of annual milk production. Therefore, the Congress could eventually reassess the level of price support relative to expected milk production and purchases.

Strengthen the Role of the Market for Export Crops. Farmers producing major export crops--grains, upland cotton, and soybeans --face even more than the normal uncertainty because of international market conditions. The nation has an interest in reducing uncertainty for these farmers while at the same time strengthening their orientation toward the market. A reduction of uncertainty stimulates farmers to invest in cost-reducing technology, since they can feel more assured of a return on their investment. The following options would be consistent with recent national policy. One option would eliminate deficiency payments to farmers that supplement their incomes in years when crop prices are low. Another option would provide a program of revenue insurance.

Eliminating deficiency payments could save up to $4 billion annually without detriment to domestic agriculture (see Appendix A-350-c). The Congress authorized these payments in the mid-1970s for wheat, feed grain, upland cotton, and rice to smooth the transition toward fuller participation in the world market. They are based on differences between target prices and market prices.

Over the crop years 1974-1980, deficiency payments totaled about $2.5 billion. In 1981 alone, however, they amounted to about $1 billion because of higher target prices, low crop prices, and increased participation by farmers in commodity programs. The payments were highly concentrated among larger farmers, and were of small consequence to others.

The Agriculture and Food Act of 1981 continues deficiency payments for the 1982-1985 crop years. While CBO's baseline projection includes no deficiency payments for most of that period, it estimates that low farm prices near loan rates could trigger payments of up to $4 billion yearly.

Given the evolution of agricultural policy, deficiency payments have largely fulfilled their function. Farmers have demonstrated a willingness and ability to supply food and fiber at prevailing world market prices, so that deficiency payments could now be eliminated without detriment to domestic agriculture. Other provisions of existing commodity programs--the farmer-owned reserve, crop loans, and acreage diversion payments--could be used, if needed, to prevent large drops in crop farmers' incomes. One drawback is that these provisions might not, by themselves, offer farmers sufficient incentive to take land out of use during periods of surplus production. An attraction of deficiency payments has been that they provided farmers the incentive to participate in cropland set-aside programs, thereby helping to stabilize prices and output.

A voluntary revenue insurance program could be designed to provide individual farmers protection against the hazards of variable export demand, erratic foreign exchange rates, or export embargoes, and also against crop production losses. It could be used in place of traditional commodity programs and emergency disaster loans.

A revenue insurance program could be an extension and expansion of the federal crop insurance program administered by the Federal Crop Insurance Corporation (FCIC). Federal crop insurance is all-risk (natural hazard) insurance. It guarantees a farmer that poor yields will not reduce revenue per acre below 75 percent of expected revenue based on normal yield and a selected price. Lower levels of protection can be selected, and premiums--30 percent subsidized--vary directly with the level of yield guarantee and price selection. Insurance companies and independent agents market federal crop insurance, and some companies participate in reinsurance schemes with the FCIC and share in the profits or losses. The revenue insurance program could be similarly operated.

Federal crop insurance provides protection against revenue losses arising from changes in output. A revenue insurance program would add protection against changes in market prices. Revenue insurance would guarantee a farmer that his revenue per acre for a specific crop would not fall below its normal range. For example, if a farm's annual revenue per acre of corn normally fluctuates within a range of plus or minus [illegible] percent, the government might insure that the farmer's revenue would not fall below that range, thereby requiring the farmer to bear the risk of "normal" revenue variability. The midpoint of the range would be determined on the basis of the farm's average yield and recent average prices. Premiums would reflect the level of revenue guaranteed.

In effect, revenue insurance would assure participating farmers a minimum level of revenue per acre regardless of production or price variability. Furthermore, with this type of revenue protection, the government would not have to use traditional commodity program mechanisms to support and stabilize prices and incomes.

Eventually, farmers might bear all the costs of a revenue insurance program. Compared with the projected costs of commodity programs and emergency disaster loans, the net budget savings would then be about $3.0 billion. Initially, however, premiums could be partly subsidized to encourage participation. With subsidies, the peak annual costs of a revenue insurance program might be $2 billion.

Revenue insurance would reduce income variability for farmers, and would tend to encourage production, but farm prices would likely fluctuate more widely in the absence of stabilizing mechanisms such as commodity loans and the farmer-owned grainreserve. Since relatively stable supplies and prices are of importance to consumers, a domestic reserve, particularly for grains, might be needed. A government-owned grain reserve could be established, with the government purchasing grains in the open market and releasing them under prescribed rules. A grain reserve equal to 15 percent of average U.S. grain exports would cost $2 billion to establish and entail annual carrying costs of $400 million.

Shifting Some Expenditures to States or Local Governments or to Private Groups

Two federal agriculture programs could be financed through other channels.

Reduce Federal Support of Extension Education. Extension education activities help people identify and solve their farm, home, and community problems through the use of research findings of the Department of Agriculture and state land grant colleges. State and county extension work is financed from federal, state, county, and local sources. Federal funds--which account for about 40 percent of overall extension financing--are mainly distributed to the states by prescribed formula. In 1981, the federal share was about $300 million.

Extension education programs once provided farmers much of their information about new production technology and ways to improve family living. Today's farm families are far better educated, more fully integrated into the nonfarm economy, and obtain information from a wider range of sources. For the most part, extension activities today are oriented toward improving the quality of life for rural and urban citizens.

The level of federal support of extension education activities might be reduced without detriment to the nation's long-term supplies of agricultural products. A 25 percent reduction in formula funds to states would save about $60 million annually and reduce total extension funding by about 7 percent. The reduction in federal funds would mean that state, county, and local governments would have to increase their share of extension education costs or else reduce the level of such activities (see Appendix A-350-f).

Terminate Federal Funding of Foreign Market Development. The federal government provides funding for overseas market development projects of cooperators (nonprofit commodity groups), regional groups representing 44 state departments of agriculture, and private firms. It also supports cooperator offices overseas that conduct promotion activities. In 1980, the federal government spent $20 million supporting foreign market development activities; about twice that amount was spent by cooperators in this country and abroad.

The program is based on the premise that developing foreign markets is too costly and risky for private groups. But there is little indication that federal financing has been critical to increasing exports. Furthermore, there is a tendency for cooperators to rely on federal funds long after they have become established and experienced in foreign market development. Since new cooperators are continually seeking and receiving federal assistance, federal outlays increase annually.

The federal government could discontinue its cost-sharing of overseas market development, thereby saving approximately $145 million in 1983-1987 (see Appendix A-350-g). In the absence of federal funds, private groups would have to assess the costs and benefits of their projects and decide whether to increase their contributions or reduce the scale of activity. Even though the federal government stopped giving direct financial support to these groups, its market development specialists could continue to provide technical assistance.

CONCLUDING COMMENTS

Real outlays for agriculture have been declining, and now account for about 1 percent of total federal outlays. Some further reductions in agricultural outlays could be made by shifting the financing of certain programs to state and local governments or to the private sector. Considerably larger budget reductions could be made through changes in commodity programs, which account for two-thirds of agriculture outlays. The trend of the last two decades has been to reduce the federal role in the production and marketing of farm commodities and to increase the role of market forces. The continuation of this policy, particularly for dairy farmers, offers the greatest potential for future budget reductions.

CHAPTER VII. TRANSPORTATION, COMMERCE AND HOUSING CREDIT, AND COMMUNITY AND REGIONAL DEVELOPMENT

The budget functions encompassing transportation (400), commerce and housing credit (370), and community and regional development (450) cover a wide range of activities designed to foster economic growth and development. (For brevity, this chapter refers to programs funded under these functions as transportation and development activities.) Federal support for transportation provides funds to plan, build, maintain, and operate mass transit systems, highways, railroad service, airports and airways, and ocean shipping. 1/ Programs under the commerce and housing credit function promote employment and commerce and ensure the availability of credit for various housing and business undertakings. These programs include direct and guaranteed housing loans; mortgage purchase, guarantee, and insurance activities; loans and loan guarantees to private businesses; and various other business assistance efforts. The community and regional development programs support local economic development efforts by offering grants, loans, loan guarantees, and technical assistance to states and localities; this support is designated for public works, community facilities, and economic development and revitalization projects.

BUDGET HISTORY AND PROJECTIONS

Over the last decade, total budget outlays for transportation and development programs increased at an average annual rate of about 11 percent to an aggregate level of about $37 billion in fiscal year 1981. Transportation accounted for more than half of these expenditures--about $23.3 billion. Community and regional development accounted for about $9.4 billion, and commerce and

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1. Expenditures by the U.S. Army Corps of Engineers for inland waterways and deep-draft navigation--included in budget function 300--are also discussed in this chapter as part of the transportation program area. Expenditure totals and tables in this chapter do not, however, include these expenditures by the Corps. Instead, all Corps expenditures are included in the tables and expenditures totals contained in Chapter V.

housing credit for the remaining $4 billion. The baseline projections for transportation and development reflect a slower growth rate than in the past, with total spending falling to an average annual rate of about 3 percent over the next five years.

Historical Trends, 1970-1981

Transportation and development programs have accounted for a relatively stable share of total federal expenditures over the last decade: somewhat less than 6 percent. Federal outlays in these categories more than tripled during this period, from $11.5 billion in 1970 to almost $37 billion in 1981--about the same rate of increase as occurred in total federal outlays. Federal expenditures in each of the three budget functions grew at different rates, however. While transportation outlays more than tripled between 1970 and 1981 and community and regional development outlays increased by almost four times, outlays for commerce and housing credit did not quite double. Federal expenditures for transportation and development thus shifted away from commerce and housing credit activities to transportation and community and regional development programs.

The allocation of federal expenditures for transportation and development also shifted within the separate budget functions and program areas (see Table VII-1). The emphasis of transportation expenditures shifted away from highways (and to a lesser extent, from air and maritime activities) to mass transit and railroads. Highway funding accounted for 65 percent of total transportation expenditures in 1970 but fell to only 40 percent in 1981. At the same time, expenditures for mass transit and railroads climbed from less than 2 percent of total transportation expenditures in 1970 to 33 percent in 1981.

Similarly, federal outlays for commerce and housing credit shifted away from subsidies for postal service and other direct expenditure programs to mortgage credit programs. Federal expenditures for mail service declined in absolute terms, from $1.5 billion in 1970 to $1.3 billion in 1981, while federal outlays for housing credit grew to more than $2.0 billion in 1981--a significant increase from 1970, when these activities accounted for slightly less than $600 million in federal outlays.

Federal outlays for community and regional development have also shifted in emphasis over the last decade--away from community development efforts to area and regional development and disaster

TABLE VII-1. FEDERAL OUTLAYS FOR TRANSPORTATION, COMMERCE AND HOUSING CREDIT, AND COMMUNITY AND REGIONAL DEVELOPMENT (In billions of dollars)

Programs	Actual 1970	Actual 1981	Estimated 1982	Baseline Projection 1983	Baseline Projection 1987
Transportation					
Highways	4.56	9.48	8.73	8.75	11.42
Mass Transit	0.11	3.92	3.94	4.22	4.67
Railroads	0.02	3.70	2.07	1.25	1.41
Air	1.42	3.78	3.60	3.68	4.01
Maritime	0.91	2.42	2.64	2.74	3.30
Other	0.02	0.01	0.22a/	0.24	0.25
Pay Raises b/	---	---	---	0.26	1.49
Subtotal	7.04	23.31	21.20	21.14	26.55
Commerce and Housing Credit					
Housing Credit c/	0.59	2.05	3.04	2.32	5.34
Banking and Finance	-0.50	-1.36	-1.12	-1.57	-2.37
Postal Service	1.51	1.34	0.83	0.81	0.80
Small Business Assistance	0.15	0.81	0.74	0.71	0.77
Other	0.35	1.16	1.12	1.07	1.13
Pay Raises b/	---	---	---	0.06	0.37
Subtotal	2.11	4.01	4.62	3.41	6.04
Community and Regional Development					
Community	1.45	5.00	5.07	4.72	5.29
Area and Regional	0.69	2.71	2.77	2.22	2.32
Disaster Assistance	0.25	1.71	1.05	1.05	1.43
Pay Raises b/	---	---	---	0.05	0.30
Subtotal	2.39	9.42	8.90	8.04	9.34
Total	11.54	36.74	34.71	32.59	41.93

NOTES: Details may not add to subtotals or totals because of rounding. Minus sign denotes receipts in excess of outlays.

a. Includes pay supplementals and offsetting receipts

b. See Table IV-1, footnote a, for distribution of pay raises.

c. Housing credit was classified as part of the community and regional development budget function in 1970 but is currently classified as part of the commerce budget function.

assistance programs. Between 1970 and 1981, outlays for community development fell from 61 percent to 53 percent of total outlays in this category. At the same time, spending for area and regional development and disaster assistance rose at a faster rate than total federal expenditures--area and regional development expenditures increased almost four-fold and disaster assistance almost seven-fold.

To some extent, these expenditure shifts reflect geographic changes in population and economic activity, combined with continued growth in per capita income. For example, regional shifts in economic activity from the older, industrialized areas of the Northeast and Midwest (the frostbelt) to the Southwest (the sunbelt) contributed to the decline of several large freight railroads, including the Penn Central, Rock Island, and Milwaukee railroads. In 1976, the bankruptcy of the Penn Central culminated in the consolidation of seven eastern railroads into the Consolidated Rail Corporation (Conrail); since its creation, Conrail has required more than $5.5 billion in federal aid. Similarly, the financial collapse of the Rock Island and Milwaukee railroads has resulted in additional subsidies. Consequently, total federal aid to railroads grew from $17 million in 1970 to practically $4 billion in 1982. 2/

Similarly, the continuing suburbanization of population and economic activity, combined with growing per capita income, stimulated the use of passenger cars and a concurrent decline in mass transit. The rise in federal support for urban highways reflected the changing transportation needs of this increasingly suburbanized population. At the same time, however, government at all levels attempted to divert this shift away from public transit by subsidizing fares to keep them low and by extending service areas. Such efforts have greatly enlarged the deficits associated with transit operations. As a result, federal aid for transit grew from 1.6 percent of federal transportation expenditures in 1970 to almost 17 percent in 1981. Similarly, the increased funding for rural development, which rose by nearly 300 percent between 1970 and 1981, also partly reflected federal efforts to dampen the adverse economic effects of population migrations--in this case, from rural to metropolitan areas.

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2. The 1981 outlay total for railroads is distorted by $2.13 billion paid in settlement of the Conrail property dispute. The 1982 outlay estimate includes another $0.55 billion for the same purpose, which should complete the settlement.

One general trend in federal expenditures that emerged over the 1970-1981 decade is a shift away from federal support of public-sector activities to private business endeavors. Throughout the 1960s and early 1970s, federal programs were aimed primarily at augmenting public-sector capacity to deal with economic development problems. In the last few years, however, the overall thrust in federal policy has gone much farther toward aiding the business sector as a means of promoting revitalization in distressed or lagging areas. An example is the Urban Development Action Grants program, established in 1977 under the U.S. Department of Housing and Urban Development to create new jobs by assisting businesses in distressed areas. Moreover, recent changes in the Community Development Block Grant program may somewhat shift its emphasis away from public-sector activities and toward business development. This same trend is also reflected by increases in direct business assistance programs (in particular, disaster relief and small business assistance) and aid to specific private and quasi-private corporations--notably Amtrak, Chrysler, Conrail, and Lockheed.

The 1982 Budget Decisions

In the 1981 reconciliation act and in appropriations actions for 1982, the Congress made significant reductions in funding for all the transportation and development functions. Total 1982 budget authority for these functions is 15 percent below the 1981 level, and 1982 appropriations to date are 21 percent below the 1981 appropriated levels.

Transportation. Sizable reductions have been made in transportation programs. Funding for urban mass transit has been cut from $4.7 billion in 1981 to $3.5 billion in 1982, with most of the reductions affecting capital grants. Budget authority for the federal-aid highway program is $8.3 billion in 1982 (down from $9.1 billion in 1981), and the ceiling on federal-aid highway obligations has been lowered from $8.75 billion in 1981 to $8.0 billion in 1982. Other large reductions have been made in funding for Federal Aviation Administration operations (down $245 million) and facilities and equipment purchases (down $90 million), as well as for the Maritime Administration's ship construction program (down $135 million).

Appropriations for Amtrak have also been cut, from $881 million in 1981 to $735 million in 1982. Nevertheless, because the reconciliation act allowed Amtrak to forego interest payments on its federal debt and made other changes that will decrease costs, Amtrak will be able to provide approximately the same level of service in 1982 that was offered in 1981; however, its capital acquisition program will be reduced. Similarly, payments to Conrail have been reduced, from $400 million in 1981 to $85 million in 1982. In addition, the reconciliation act modified labor protection provisions, established a program for reducing the number of Conrail employees, and set a schedule for the sale of Conrail to the private sector if profitability goals are not met--all intended to reduce long-term federal costs in this area.

Commerce and Housing Credit. The U.S. Postal Service (USPS) requested an appropriation for 1982 of $1.5 billion to compensate for Congressionally mandated service levels, reduced revenues from certain classes of mailers, and other expenses incurred by the former Post Office Department. In his March budget request, President Reagan proposed a payment of $869 million to the USPS, a reduction of more than 40 percent. Although a ceiling of $946 million was established in the reconciliation act, the continuing resolution provides appropriations of only $834 million for 1982.

Reductions in small business loans were also made in 1982. In his March 1981 budget request, President Reagan recommended approximately $260 million in direct loans and $3.15 billion in guaranteed loans to small businesses. These program levels were some 30 to 40 percent lower than 1981 levels. As provided in the continuing resolution, guaranteed loans will be $3.3 billion and direct loan levels will be further reduced to $225 million. Smaller reductions have also been made in other small business activities and administration.

Community and Regional Development. The reconciliation act eliminated two small community development programs--comprehensive planning grants and the neighborhood self-help development program--and reduced funding for larger community development programs. The Community Development Block Grant program was cut 6 percent and the Urban Development Action Grant program was reduced 35 percent. The rehabilitation loan fund received no new monies, but it was allowed to continue making loans with loan repayments. Reconciliation also set authorization ceilings that will reduce possible future funding levels for community development programs. In total, 1982 appropriations for community development programs fell 11 percent below 1981 levels.

Appropriations for fiscal year 1982 for area and regional development programs totaled $1.9 billion, $1.5 billion below the level that CBO estimates indicate would be needed in 1982 to maintain those programs at initial 1981 levels. That appropriation level reflects the adoption of many of the reforms and funding reductions submitted by the Administration in March 1981, although the Congress provided more funding than the Administration requested for some programs. The Congress retained, for instance, the basic functions of both the Appalachian Regional Commission and the Economic Development Administration at reduced funding levels, whereas the President had requested their elimination.

Disaster assistance programs were untouched by the reconciliation act, with the notable exception of the Small Business Administration's Disaster Loan Program. In 1981, the Congress significantly altered this program by narrowing eligibility requirements and modifying loan terms; both these measures are expected to reduce loan demand and the net federal cost for disaster loan assistance.

Baseline Projections, 1983-1987

Growth in federal outlays for transportation and development is projected to slow in the near future as a result of the 1982 budget decisions. Baseline outlays for these functional areas are projected to increase by $7.22 billion (or 21 percent) by 1987. Transportation outlays account for most of this growth--about $5.35 billion by 1987. Nevertheless, transportation outlays are projected to rise at a slower rate than in the past--4.6 percent a year, compared with a past annual rate of about 10.5 percent. Expenditures for highway and maritime activities increase the fastest, while outlays for rail programs fall below their 1982 levels (see footnote 2).

The commerce and housing credit function accounts for most of the remaining projected growth--about $1.42 billion by 1987. Outlays in this function are projected to grow at a slightly slower rate than in the past--about 5.5 percent annually, compared to about 7.5 percent in the past--with virtually all of this growth occurring in the housing credit programs.

Community and regional development programs are projected to see little outlay growth over the next five years, since current expenditure levels include a large balance of previously appropriated funds that are projected to spend out in the near term. Annual outlays for this function are projected to grow by less than 1 percent, compared with historical yearly rates of about

12.5 percent. Baseline outlays for area and regional development actually decline from 1982 levels, falling by about $450 million by 1987.

BUDGET STRATEGIES

Federal expenditures for transportation and regional development could be reduced through a variety of strategies. Although very large budget reductions would ultimately require a restructuring of federal roles and priorities, significant reductions could nonetheless be achieved within the current governmental framework. These reduction strategies include:

- Increasing user fees;
- Shifting responsibilities to state and local governments;
- Targeting funds to the neediest areas and populations; and
- Reducing subsidies for private-sector activities.

Increasing User Fees

A large portion of federal expenditures for transportation and development is currently funded through user fees. The justification for user fees rests in the fact that, though many federal activities under these budget functions could not efficiently be provided by the private market, they yield significant benefits to specific classes of users, many of whom have the ability to pay. These beneficiaries can be identified and charged for the costs incurred by the government (producing revenues or offsetting receipts), thereby promoting efficient allocation of resources. 3/ Federal intervention is simply necessary to coordinate, rather than subsidize, these activities. In many cases, however, the current user fees do not recover the full costs of specific goods or services, and in some instances, no user fees at all are now imposed. Such undercharges distort the allocation of resources among competing purposes.

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3. Most of the specific options discussed in this chapter would increase revenues. Some, however, would be reflected in reduced outlays since they are offsetting receipts. Either way, the budget deficit is reduced.

Existing User Fees. The largest user charges now in effect are those levied against transportation users. In 1981, the revenues from user charges recovered almost half of the $23.3 billion in federal expenditures for the transportation budget function (see footnote 1). Reliance on user fees varies considerably among individual transportation modes, however.

The primary transportation user charges are those that finance the highway and airway programs. Highway user charges (a series of excise taxes on gasoline, diesel fuel, oil, tires, and trucks and truck parts) are earmarked and set aside in the Highway Trust Fund for use only in highway programs. This mechanism is intended to make the federal highway program self-supporting: beneficiaries are charged for what they receive. Similarly, the Airport and Airway Trust Fund, established in 1970 to fund federal expenditures for airports and airways, is financed through passenger ticket taxes and certain other taxes paid by airport and airway users. The user-financing mechanism was also recently extended to inland waterways. Inland waterway user charges, in the form of a fuel tax, took effect in 1981 and will be phased in over the next five years, rising from 4 cents per gallon at the outset to 10 cents per gallon in 1986 and thereafter.

Although user charges contribute significantly to the federal effort in highways, airways, and to a lesser extent, waterways, current revenues fall short of specific program costs. About 96 percent of federal highway spending in 1981 was financed through user fees paid into the Highway Trust Fund. 4/ Similarly, user fees funded about 42 percent of all federal expenditures for airway capital and operating costs; the Airport and Airways Trust Fund financed only about 23 percent of the airway system's operating costs in 1981, despite a trust fund surplus of about $3 billion. Inland waterway user charges funded less than 5 percent of 1981 expenditures and, although increases in these charges are planned, they are projected to fund only about 9 percent of federal inland waterway expenditures in 1987.

Federal deficits could be reduced by extending current financing mechanisms to shift to users more of the federal costs for highways, airways, and inland waterways. Full recovery of all

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4. This estimate only accounts for highway expenditures under budget function 400 (transportation). Additional highway expenditures--included under other budget functions and funded from general funds--totaled more than $1.0 billion in 1981.

federal costs for highways (including highway expenditures outside the transportation budget function), airways, and inland waterways would reduce net federal expenditures (federal outlays less revenues from users) by about \$3.5 billion in 1983--\$1.5 billion for highways, \$730 million for inland waterways, and \$1.3 billion for airways (see Appendix B-300-c and A-400-e). Moreover, as the costs borne by users increase, some reduction in total federal outlays may be realized, as beneficiaries of the various services respond to the increased costs by lowering demand.

Increasing user charges raises questions regarding the proper allocation of costs and tax receipts among the various subsidiary modes. For example, general aviation (mainly planes owned by firms and individuals for their own business and personal use) has historically paid only a small proportion--less than 15 percent--of its share of federal aviation expenditures, while commercial air carriers, through ticket taxes and other fees, have generally paid most of their attributable costs. Increased user fees for air transportation could therefore be accompanied by a shift in the cost burden to general aviation (see Appendix B-400--a). Similarly, although conclusive findings are not yet available, the heaviest classes of trucks do not appear to pay their full share of federal highway costs. Although federal highway expenditures are largely offset by user fees, a restructuring of highway user fees to reflect more nearly the costs occasioned by various classes of highway users would be more equitable, and it would also promote a more efficient transportation network.

New User Fees. The user-charge principle could also be extended to other federally funded transportation activities, specifically maritime activities carried out by the U.S. Army Corps of Engineers and the Coast Guard. The Corps of Engineers spends about \$500 million each year to improve and maintain ports and channels to accommodate oceangoing vessels. In addition, the Coast Guard spends more than \$1 billion annually on activities that benefit commercial and recreational boaters. These activities include navigational aids for commercial shipping, search-and-rescue operations for private mariners (mostly recreational boaters) who are lost or otherwise in trouble, and marine safety.

As with other modes of transportation, the cost of the activities listed could be recovered, at least in part, directly from the beneficiaries--specifically, the commercial shipping industry and recreational boaters (see Appendix B-300-d and B-400-b). Though these activities have traditionally been subsidized by the federal government, there is no inherent reason why the user-charge principle could not be extended to encompass these functions. For example, with 1.4 million large recreational boats berthed in coastal areas and more than 10 million recreational boats in inland waters, a modest annual (registration) fee could be assessed to recover the search-and-rescue costs attributable to recreational boaters. Full recovery of the allocable federal costs for these navigation and recreational boating activities would reduce net federal expenditures by about $1.2 billion in 1983 and might result in some reduction in total federal outlays as users responded to the increased costs by lowering demand for services.

The primary arguments against imposing user charges for navigation and search-and-rescue activities include the difficulty in establishing fair cost allocations among the various kinds of users, the administrative problems in collecting a new set of fees, and the potential reductions in shipping and boating activities resulting from increased user costs. Given the very small cost increases (relative to total current user costs) implied by these fees, however, such effects would be minor. Moreover, potential disruptive impacts could be minimized by phasing in the implementation of these fees.

The user-charge principle could also be extended to a variety of activities in the commerce area. At present, user charges are levied for a number of services performed or information provided by the Department of Commerce, including economic and statistical data in the areas of commerce, trade, and science. User-charge receipts for these activities could be increased by as much as $50 million, however, if fees were extended or increased to recover all appropriately assignable costs. In addition, the Monetary Policy Control Act of 1980 established user fees for various services of the Federal Reserve Bank, including check collection, electronic funds transfer, and coin wrapping. These charges yielded around $150 million in 1981 (calendar year) and will grow in 1982 and thereafter as other provisions of the act are phased in. Similar user charges could be extended to services provided by the Federal Communications Commission (FCC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). For example, authorizing legislation now pending in the House (H.R. 3239) and the Senate (S. 821) would establish fees for the FCC that would result in an additional $30 million in annual receipts to the federal government. Altogether, increased user charges in the commerce area could yield upwards of $100 million a year in new federal receipts after 1982.

In sum, the increases in user fees discussed above could reduce net federal expenditures by more than $4.8 billion annually. Full recovery of total federal costs for highways, airways, and inland waterways could reduce net federal expenditures by about $3.5 billion in 1983. Extending the user-charge principle to the deep-draft navigation and recreational boating activities carried out by the Army Corps of Engineers and the Coast Guard could reduce net federal expenditures by an additional $1.2 billion annually. Additional receipts of roughly $100 million could probably be realized by additional user charges for services provided by the Commerce department, the FCC, the SEC, and the CFTC.

Shifting Responsibility to State and Local Governments

Federal programs for transportation and development extend large amounts of federal aid to state and local governments. In 1981, such federal aid reached about $19 billion, or 52 percent of total federal transportation and development expenditures. Thus, one strategy for reducing the federal budget would be to reduce local aid, shifting ultimate financial responsibility for various activities, particularly transportation, to lower levels of government.

The justification for such a transfer of financial responsibilities is that many of the activities funded convey very localized benefits and that such activities are more appropriately funded by the particular beneficiaries--the localities--rather than by the general taxpayer. Furthermore, many of the activities that now receive federal support might be more efficiently funded and carried out at the local level. State and local officials in general are most aware of local conditions and needs. Moreover, federal support for various activities has probably resulted in some perverse incentives to states and localities (discussed below). Shifting financial responsibilities to state and local government therefore might result in more efficient allocation of scarce resources.

One way to curtail federal financial responsibility would be to restrict federal aid to programs or projects that are truly national in scope. For example, federal highway aid could be limited to routes that primarily serve interstate travel; federal support for essentially local highway systems or segments could be terminated. The National System of Interstate and Defense Highways now includes many urban segments that carry little other than local traffic. Moreover, federal funds are provided for secondary and urban roads that are not part of the Interstate Highway System and that are serving local needs. The Interstate Highway System could be redefined to include those projects that serve truly interstate commerce and passenger travel, resulting in an estimated five-year savings of about $9 billion in outlays (see Appendix A-400-d). Morever, terminating federal aid for secondary and urban roads could reduce outlays by an additional $5 billion over the next five years. Thus, leaving financial responsibility for local routes to the state and local governments could result in significant federal savings over the next five years--$25.7 billion in budget authority and $14.3 billion in outlays.

Similarly, substantial savings could be realized by terminating all capital aid for local mass transit systems--about $7 billion in outlays over the next five years--and discontinuing mass transit operating subsidies for annual outlay savings of about $1 billion (see Appendix A-400-b and A-400-c). Likewise, grants-in-aid for large airports could be terminated, resulting in a five-year outlay savings of about $800 million (see Appendix A-400-f).

Despite federal budget savings and potential improvements in resource allocation, however, sudden elimination of all federal aid for various state and local activities might be an undesirable course of action. Financial burdens on state and local governments would increase, and many services or activities would probably be cut or sharply curtailed. Moreover, federal assistance may serve another important function--to ensure an equitable distribution of resources among localities and populations that have varying fiscal capacities to support local services. .Terminating all state and local aid would therefore have adverse equity effects.

Maintaining federal support for various local activities at lower funding levels (with the potential long-term goal of phasing out all federal aid) could lessen the disruptions and hardships felt by state and local governments. For example, one alternative to eliminating all capital grants for mass transit would be to lower the federal matching ratio from its current level (see Appendix A-400-c). At present, the federal government distributes $2.5 billion a year to urban areas for mass transit capital grants on an 80-to-20 federal-to-local matching basis. This high federal matching ratio creates an incentive for states and localities to over-invest in capital facilities, and it may promote premature, hence uneconomical, retirement of capital stock. Lowering the federal match from 80 to 50 percent would result in significant budgetary savings--about $2.9 billion in outlays over the next five years--while limiting disruptions to state and local governments and reducing perverse investment incentives. Similarly, additional savings could be realized by scaling back (instead of entirely eliminating) federal expenditures for other local activities, such as transit operating subsidies, aid for local highways and streets, and grants-in-aid for large airports.

Alternatively, reductions in federal funding support for state and local activities might be achieved by consolidating assorted categorical grant programs into a large block grant or revenue sharing program (discussed elsewhere in this report). For example, a number of capital grants that are used to maintain, replace, and develop local infrastructure (such as grants for highways, mass transit, and sewage facilities) could be consolidated into one large grant for public construction. This approach would enhance local flexibility in allocating funds and could thereby promote efficient allocation of resources. Moreover, the federal objective of promoting an equitable distribution of resources among localities could be maintained. At the same time, however, it should be noted that consolidating grants can at times diminish the degree to which recipient states and localities use their grant monies to pursue national policy objectives.

Targeting Funds to the Neediest Areas and Populations

Federal transportation and development programs now benefit a variety of recipients. Targeting federal expenditures to those areas, populations, or beneficiaries with the greatest need or benefit potential could result in significant budgetary savings while enhancing the cost effectiveness of federal expenditures.

This reduction strategy is particularly applicable in the area of community and regional development, in which the effectiveness of federal expenditures depends on the federal government's ability to direct funds to areas and populations with serious economic and social problems and to assist only those undertakings that could not otherwise be funded. In this regard, substantial savings could be realized by targeting federal community and regional development programs on the neediest populations or communities. An example would be a tightening of the now quite loosely restricted Community Development Block Grant (CDBG) program--itself an example of grant consolidation dating back to 1974--which will disburse some $3.5 billion in federal funds in 1982. (The CDBG program replaced an assortment of categorical development programs, including the Urban Renewal and Model Cities programs). Almost 700 cities and urban counties meet the CDBG eligibility requirements on the basis of population or central city designation and therefore receive aid regardless of need. These communities receive nearly 75 percent of each year's CDBG funds. If these eligibility requirements were tightened to limit CDBG funds to communities with relatively high levels of need and the funding for the program were reduced by one-fourth, outlay savings could reach $1.1 billion a year by 1987 (see Appendix A-450-a).

Similarly, other federal economic development programs often support firms or projects that could probably receive state, local, or private financing instead (see Appendix A-450-b). For example, the Farmers Home Administration (FmHA) Business and Industry program, which now guarantees an annual $300 million in private credit, appears in some instances to be unnecessary to assure private financing; it may therefore have a limited net impact on new investment and employment. Moreover, the FmHA has historically used nearly one-third of its guarantee authority for debt restructuring and ownership transfer--activities that are not necessarily linked to new investment. Similarly, some Economic Development Administration programs (totaling $154 million in 1982 outlays) and Urban Development Action Grants (totaling $500 million in outlays) support endeavors that could receive private credit or be funded locally. All three programs also aid some communities that are in relatively good economic health. Federal assistance for these local development programs could therefore be reduced by as much as one-half or more--for total five-year outlay savings of about $700 million--while the current level of aid for the most distressed areas could be maintained.

Although improved targeting of development aid could yield substantial savings for the federal budget, areas that lose funding might experience some hardship. In some communities, local projects and programs would have to be discontinued. Consequently, the cuts could bring about some erosion of local tax bases and some lost employment opportunities.

Reducing Subsidies for Private Sector Activites

The federal government also extensively subsidizes a variety of private-sector activities in the transportation and development area. Such support takes the form of grants, low-interest loans, loan guarantees, and tax expenditures.

Advocates of federal aid to various private-sector undertakings often point to the public benefits conveyed by the endeavors supported. In many instances, however, federal subsidies may convey few public benefits, or they may have continued long past their usefulness or effectiveness. For example, capital and operating subsidies to the Amtrak passenger rail system will cost the federal government $800 million in outlays during fiscal year 1982. Supporters of Amtrak's subsidies often argue for them on the basis of energy conservation, equitable income distribution, or the provision of emergency transport services. In reality, however, Amtrak's energy-conservation benefits are limited, and its income redistribution effects are minimal. Other federal policies, such as filling the Strategic Petroleum Reserve, would provide more cost-effective insurance against future energy emergencies. Completely eliminating subsidies to Amtrak would reduce 1987 outlays by about $1.1 billion. Smaller savings could be realized, however, through selective route reductions (see Appendix A-400-a).

Similarly, the U.S. shipbuilding industry also benefits from federal subsidies. In 1982, the Maritime Administration (a unit of the U.S. Department of Transportation) will provide approximately $70 million for construction subsidies to shipbuilders and a little over $400 million in operating subsidies to shipowners. These subsidies are justified as contributing to national defense by preserving the nation's maritime industry, which is threatened by foreign competitors that can build and operate ships for about one-half to two-thirds the U.S. cost. In fact, these subsidies support only a small share of U.S. maritime activities. For example, only two to six ships a year, at most, are built with federal subsidies--compared to a national total of 50 ships. Thus, subsidies to the maritime industry could be terminated--for total savings of about $620 million over the next five years--with little loss in public benefits (see Appendix A-400-g).

Federal aid also goes to low-income persons and to the elderly and handicapped, in an effort to promote equitable distribution of available resources. (As such, these activities might more aptly be described as income security programs, discussed in detail in Chapter X). Such programs include direct loans to finance housing for the elderly or handicapped, direct and guaranteed housing loans for low- and moderate-income families in rural communities, and rural rental assistance for low- and moderate-income tenants. While the federal role in ensuring a minimum standard of living for all U.S. residents is generally accepted, there maybe nonetheless some opportunity for adjusting these subsidies to achieve budgetary savings. For example, tenants living in projects financed by the FmHA rental housing program must now contribute a minimum of 25 percent of their incomes toward their housing costs; the FmHA funds the difference at an annual cost of over $100 million. By raising the minimum tenants' share to 30 percent--the percentage to be contributed (by 1986) by tenants assisted by the U.S. Department of Housing and Urban Development (HUD)--five-year savings of over $100 million in outlays could be realized (see Appendix A-370-a). Although this would probably increase the economic hardship experienced by households now receiving aid, it would place tenants in FmHA housing on a footing more comparable with that of HUD-assisted tenants.

Federal credit or loan programs are another potential area for budgetary savings. These programs are designed to make reasonably priced credit available to private-sector borrowers that are not well served by private credit markets; the private market either would not lend to many of these borrowers or would lend at prohibitively high interest rates. These programs therefore effectively subsidize federally preferred activities through lower-than-market rates on either direct loans or federally guaranteed loans. If borrowers are very risky, federal subsidies may actually approach the principal value of the loans themselves because of defaults. The default rates for some of these credit programs are, in fact, quite high. For example, the Small Business Administration (SBA) estimates that it will write off about $180 million in 1982 for defaults on outstanding direct loans (almost as much as the $225 million in new direct SBA loans to be issued this year), while default payments for outstanding SBA-guaranteed loans totaled $472 million in 1981 (appreciably more than the $316 million in direct new loans the SBA issued that year).

Significant budget savings, as well as efficient use of credit resources, could be achieved if federal loans and loan guarantee programs were curtailed. For example, terminating SBA credit activity in 1983 would not eliminate these losses entirely (since outstanding loans would not be affected), but losses could be reduced by about $2.4 billion during the 1983-1987 span (see Appendix A-370-c). 5/

Finally, the federal government often subsidizes private-sector endeavors through tax policies that indirectly assist busi-

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5. For a more complete discussion of federal credit activities, see Chapter XIII.

nesses. For example, small-issue industrial revenue bonds, which finance a variety of enterprises from manufacturing plants to tennis courts, are tax exempt under current federal law. Through the tax exemption, the federal government effectively subsidizes the borrowing costs of private industry. This subsidy will cost the federal government an estimated $1.6 billion (through lost revenues) during 1982. Eliminating tax-exempt status for industrial revenue bonds would reduce future revenue losses for total savings of $6.3 billion during the 1983-1987 span (see Appendix B-370-d). [6]

CONCLUDING COMMENTS

The various actions outlined under the four strategies discussed in this chapter offer the potential for substantial reductions in federal expenditures for transportation and development. If taken together, they could reduce federal spending by at least $10 billion and shrink the budget deficit by more than $16 billion in 1987.

Shifting costs to users, while having a minimal impact on federal outlays, could reduce the federal deficit by as much as $6.0 billion in 1987. Most of these savings--about $4.0 billion--could be achieved by shifting more federal costs to the users of highways, inland waterways, and airways. An additional $1.8 billion could be saved by assessing new user fees on the beneficiaries of federal deep-draft navigation and recreational boating activities. At least $.1 billion more could be saved through increased user fees in the commerce area.

Shifting to other levels of government the financial responsibility for activities that convey essentially local benefits (mainly in the area of transportation) could yield annual budget savings of almost $9 billion by 1987. [7] Such shifts could have

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6. For a more complete discussion of federal tax policies, see Chapter XII.

7. This $9 billion savings is not necessarily additive with the $6.0 billion savings realized through user fees. This estimbte includes about $4.4 billion in savings from transferring financial responsibility for local highways to lower levels of government while the $6.0 billion savings estimate (from increased user fees) includes about $2.0 billion in savings from shifting all federal costs to highway users.

significant effects on local fiscal conditions and equity, however. These disruptions could be dampened somewhat by phasing in the changes--inevitably delaying the near-term realization of these federal budgetary savings.

Targeting federal expenditures to the neediest areas and populations also holds the potential for significant reductions in the federal budget, particularly for community and regional development programs. Targeting community development grants more narrowly could alone result in annual budget savings of up to $1.1 billion. Moreover, federal expenditures for other community and regional development programs could be reduced by one-half or more, for outlay savings up to $250 million per year. Thus, a concerted effort at targeting federal development expenditures to the neediest areas and populations could reduce the federal budget by as much as $1.3 billion in 1987.

Finally, reducing federal subsidies for private-sector activities could result in annual budgetary savings of at least $4 billion in 1987. Reductions in direct payments or grants for private-sector activities or individuals would result in savings of more than $650 million a year. Further budget reductions of at least $675 million could be realized by reducing federal credit subsidies provided through loan and loan guarantee programs, while eliminating subsidies through tax expenditure programs could result in savings upwards of $2.6 billion.

CHAPTER VIII. EDUCATION, EMPLOYMENT AND TRAINING, SOCIAL SERVICES, AND GENERAL REVENUE SHARING

The federal government provides aid for education, employment and training, and social services through numerous, widely differing programs under budget function 500. Most of the federal aid--except for postsecondary educational assistance--is in the form of federal grants to state and local governments to support activities for which such governments are generally assumed to be primarily responsible. 1/ In these instances, the federal aid is intended to increase the overall level of services provided, to finance services that might not otherwise be available, or to ensure some minimally acceptable level of services for groups designated by the federal government as warranting special attention. Most postsecondary educational assistance, by contrast, is provided directly to students to reduce the financial burden of continuing their education.

In addition to these designated-use programs, the federal government also provides unrestricted fiscal assistance to all general-purpose local governments through the General Revenue Sharing (GRS) program, which constitutes most of budget function 850. Localities may use GRS funds to support education, employment and training, or social service efforts--areas that currently encompass nearly one-half of all local spending--or for any other purpose. 2/

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1. In addition to direct assistance programs in these areas, the federal government also subsidizes the wages of certain disadvantaged workers through the Targeted Jobs Tax Credit (TJTC) and subsidizes child day care through the Dependent Care Tax Credit, which reimburses parents for a portion of their work-related expenses for dependent care.

2. General Revenue Sharing is considered here with education, employment and training, and social services programs because local governments are assumed to use much of their GRS funds to support these activities.

BUDGET HISTORY AND PROJECTIONS

Spending for all education, employment and training, and social services programs together rose sharply during the past decade, but expenditure increases began to slow in the last few years, even before the absolute-dollar cuts enacted during the first session of the 97th Congress. Spending for General Revenue Sharing, which was initiated in the early 1970s, increased during the middle part of the decade and was cut back at the end of the decade but was unaffected by actions on the 1982 budget. If spending in all these areas increased in coming years at the rates necessary to keep pace with inflation--except where funding is already capped by legislation--outlays would rise by 25 percent between fiscal years 1982 and 1987.

Historical Trends, 1970-1981

Federal outlays for education, employment and training, and social services programs grew from $8.6 billion in fiscal year 1970 to $31.4 billion in 1981 (see Table VIII-1). The sharpest increases occurred during the middle to late 1970s as the federal government expanded the range of state and local governmental functions it helps support and broadened significantly eligibility for postsecondary student assistance. Outlays for GRS first rose and then declined during the decade.

Elementary and Secondary Education. Although few new elementary and secondary education programs were created during the past decade, spending for existing programs rose sharply, increasing from $2.8 billion in 1970 to $7 billion in 1981. Overall, spending increases at least kept pace with general price rises for most of the decade but have fallen behind inflation for the past few years. Spending for the three largest programs--Title I grants for remedial and compensatory education for disadvantaged children, grants for education of the handicapped, and vocational education grants--all grew at rates equal to or well above inflation through 1979, but increases have fallen behind inflation since then.

Postsecondary Education. Spending for postsecondary educational assistance increased nearly fivefold over the last 11 years, rising from $1.4 billion in 1970 to $6.8 billion by 1981. This increase resulted largely from the 1972 creation, and subsequent expansion, of the Pell grant program--which provides direct cash assistance for students from low-income families--and the

TABLE VIII-1. FEDERAL OUTLAYS FOR EDUCATION, EMPLOYMENT AND TRAINING, SOCIAL SERVICES, AND GENERAL PURPOSE FISCAL ASSISTANCE
(In billions of dollars)

Major Programs	Actual 1970	Actual 1981	Estimated 1982	Baseline Projection 1983	Baseline Projection 1987
Education, Employment and Training, Social Services					
Elementary and secondary education	2.8	7.0	6.1	6.0	8.0
Postsecondary education	1.4	6.8	6.9	7.7	7.8
Employment and training	1.6	9.2	5.5	5.4	6.9
Social services	2.2	6.5	6.3	6.3	8.1
Other programs a/	0.7	1.8	1.9	1.8	2.0
Pay raises b/	---	---	---	0.1	0.4
Total	8.6	31.4	26.8	27.3	33.4
General Purpose Fiscal Assistance					
General Revenue Sharing	---	5.1	4.6	4.6	5.8
Other Programs c/	0.5	1.7	1.9	2.0	2.9
Total	0.5	6.8	6.5	6.6	8.7

NOTE: Details may not add to totals because of rounding.

a. Includes research and general education aids and other labor services.

b. See Table IV-1, footnote a, for distribution of pay raises.

c. Includes smaller, specific-purpose assistance programs such as federal payments to the District of Columbia and Puerto Rico.

1978 expansion of eligibility for reduced-interest Guaranteed Student Loans (GSLs). Funding for several campus-based student assistance programs also rose during the 1970s.

Employment and Training. Spending for employment and training programs grew sharply from the beginning of the last decade through the middle to late 1970s but has declined somewhat since 1979. Two factors were responsible for the large spending increases: first, the creation in 1973 of the Comprehensive Employment and Training Act (CETA) program, which provides employment and training grants to state and local governments and to nonprofit organizations; and, second, the expansion of CETA public service employment aid during and after the 1974-1975 recession. Outlays for all employment and training efforts rose from $1.6 billion in 1970 to a peak of $10.8 billion in 1979 and declined to about $9.2 billion by 1981. 3/

Social Services. Direct federal spending for social services--covering such activities as child day care, home-based care for the elderly and handicapped, and foster care--rose sharply until the late 1970s, when funding increases began to lag behind inflation. The high-growth years included the creation in 1975 of the Title XX program of block grants to the states--the largest single source of social services spending--and expansion of numerous smaller categorical programs. Overall, social services spending nearly tripled between 1970 and 1981, from $2.2 billion to $6.5 billion. 4/

General Revenue Sharing. The General Revenue Sharing program, enacted in 1972, initially aided all state and general-purpose local governments, regardless of their fiscal capacity.

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3. Tax subsidies to employers hiring designated workers followed this same pattern. Revenue losses under such subsidies rose from $5 million in 1972, when a tax credit for employers who hired certain public assistance recipients was in effect, to $2.5 billion in 1978, when a general countercyclical tax credit for all new employment was added, and then fell to $420 million in 1981 by which time the New Jobs Tax Credit had been replaced by the Targeted Jobs Tax Credit, which focuses on economically disadvantaged workers.

4. Revenue losses for the dependent-care credit rose from $458 million in 1976--the first year it was in effect--to more than $1 billion in 1981.

By 1981, however, relative fiscal conditions had shifted sufficiently that the Congress decided to discontinue aid to state governments while maintaining support for cities, counties, and townships. Appropriations for GRS rose from $5.3 billion in 1972 to a peak of $6.9 billion by 1978 but were cut to $4.6 billion in 1981 when aid to state governments was ended. 5/ Outlays in 1981 will slightly exceed this level, however, because actual spending lags appropriations somewhat.

The 1982 Budget Decisions

The reconciliation act of 1981 and appropriations actions completed to date have significantly reduced funding for education, employment and training, and social services programs but have not affected GRS. As a result of already completed actions, it is estimated that 1982 outlays for all education, employment and training, and social services programs will be $4.6 billion lower than the 1981 level--a 15 percent absolute-dollar reduction and a substantially larger cut after taking account of inflation.

Spending reductions in these areas were accomplished through a combination of reducing aid to less needy jurisdictions and individuals, consolidating existing programs at reduced funding levels, eliminating programs deemed to be ineffective, and simply reducing funding for selected programs. Four of the major reductions are the following: limiting automatic eligibility for reduced-interest GSIs to students from families with incomes below $30,000 while requiring higher-income students to demonstrate financial need; consolidating numerous elementary and secondary education programs into a single, loosely restricted block grant at a reduced level of funding; eliminating the public service employment programs funded under CETA and substantially cutting CETA training assistance; and reducing Title XX social service grants by nearly one-fifth. In the last case, the funding reduction was accompanied by the elimination of a requirement that

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5. Between 1977 and 1979, $3.3 billion in antirecession fiscal assistance was also allocated to state and local governments.

states use their funds to benefit primarily less well-off families. 6/

Baseline Projections, 1983-1987

The CBO projects that, if spending for education, employment and training, and social service programs were allowed to increase at rates sufficient to provide 1982 levels of services in the future--except where funding is already capped by legislation--spending in these areas would grow from $26.8 billion in 1982 to $27.3 billion in 1983 and $33.4 billion by 1987. Spending for General Revenue Sharing remains capped at $4.6 billion in 1983 but, if allowed to increase with inflation after that, would rise to $5.8 billion by 1987. Almost all of these spending increases would be the result of growth in discretionary appropriations.

BUDGET STRATEGIES

If the Congress chooses to reduce spending further in these areas, deciding where and how will involve determining what types of federal support to withdraw from which jurisdictions or individuals. At least two general approaches are available:

- Reducing assistance for some present, less needy recipients, so that remaining aid is directed to the most disadvantaged jurisdictions or individuals; and

- Reducing the federal role more generally in selected areas by trimming ineffective programs or by curtailing activities considered more appropriately the responsibility of other levels of government or the private sector.

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6. Paralleling these spending cuts, the Economic Recovery Tax Act of 1981 made ineligible for the TJTC certain workers who are not economically disadvantaged, while expanding coverage to include persons terminated from federally funded public service employment jobs. That act also increased subsidies provided under the Dependent Care Tax Credit, benefiting primarily middle- and upper-income families.

The first approach--increasing the targeting of present programs--requires judgments regarding which current recipients should continue to receive assistance and which should be expected to be able to finance services with their own resources. The second approach--more generally reducing the federal role in selected areas--requires decisions concerning which programs are least effective or which federally financed services should more appropriately be funded either by other levels of government or by individuals without government aid.

Increasing Targeting

One means of achieving additional savings in the education, employment and training, social services, and revenue sharing area would be to reduce aid only for less needy recipients, reserving what assistance is available for those least able to finance services on their own. This could be done by making better-off jurisdictions or individuals ineligible for aid, by eliminating the untargeted portion of programs, or by requiring that less needy jurisdictions match some share of any federal aid received with their own resources.

Specific options for increasing program targeting include: eliminating the untargeted portion of vocational education assistance; restricting eligibility for in-school interest payments on Guaranteed Student Loans; requiring that less fiscally stressed jurisdictions match a portion of the federal funds provided under CETA; and providing GRS funding only to fiscally stressed local governments.

Further Targeting of Vocational Education Assistance. One example of selectively reducing federal support would be to eliminate funding for the untargeted portion of vocational education assistance. About half of the approximately $700 million expected to be spent in 1982 under the Vocational Education Act (VEA) is unrestricted, so that states and localities may use the funds to support basic programs--principally occupational training courses serving youths who are not generally disadvantaged. The Congress restricts the uses of the remaining funds by targeting them on certain disadvantaged population groups or by mandating certain activities, such as bilingual education and program improvement efforts.

If current expenditures under the VEA were cut in half, retaining only those expenditures that are targeted to support specific federal goals, outlay savings would total $1.5 billion over the 1983-1987 period (see Appendix A-500-b). This would be unlikely to have a seriously adverse effect on state and local programs since the federal contribution to vocational education is already less than 10 percent of total expenditures. There is strong support for basic programs in vocational education at the state and local level, so that their continuation would not likely be threatened by a cutback in the federal contribution. On the other hand, any such cutback could impose some hardship on economically pressed jurisdictions and would probably result in some reduction in vocational education efforts in those areas.

Another means of reducing funding for vocational education would be to fold the current program into the general elementary and secondary education block grant at a reduced funding level. If such an approach were adopted, however, focusing of the currently targeted portion of VEA assistance might be lost unless some set-aside or targeting requirement were imposed within the expanded block grant. But that in turn would reduce local discretion in determining spending priorities--one of the principal benefits claimed of any block grant. The savings under this approach would depend on how sharply vocational education funding was cut back within the expanded block grant.

Eliminating In-School Interest Payments on GSLs for Graduate Students. Outlays for Guaranteed Student Loans (GSLs)--expected to total $3.1 billion in 1982--could be reduced by requiring that graduate students, for whom the full subsidy is probably less necessary, begin to pay interest on their loans from the time they borrow, rather than beginning six months after they leave school as is now the case (See Appendix A-500-d). Currently, all borrowers under the GSL program receive loans at 9 percent interest rates (7 percent if they took out their first loans before January 1, 1981). The federal government pays the private lenders the difference between payments due under that reduced interest rate and what would be due if the loan yielded a market rate of return tied to the federal cost of borrowing. In addition, the government makes all interest payments on behalf of borrowers as long as they are in school. These in-school interest payments currently amount to nearly one-half of the value of the subsidy over the life of the loan.

Eliminating the in-school interest payments for graduate students would still allow those borrowers to repay their loans at 7 or 9 percent interest rates. Under this option, however, the additional subsidy provided by the in-school interest payments would be denied to persons whose advanced education would, presumably, improve their long-term income prospects, making them better able to shoulder the cost of continuing their education. Such a change would reduce federal outlays by about $900 million during 1983-1987.

Requiring Less Fiscally Stressed Jurisdictions to Match a Portion of the Funding Provided Under CETA. An option for further targeting federal aid in the employment and training area would be to require that less fiscally stressed states or localities match some share of their federal CETA grants with their own funds. Such a requirement could then be accompanied by a reduction in total federal funding equal to the amount the less stressed jurisdictions would be expected to provide for themselves. The fiscal strain that any such matching requirement might place on recipient governments could be alleviated somewhat by varying the size of the matching requirement. Requiring that all but the most needy jurisdictions provide some share of total funding would ensure that those jurisdictions able to do so would devote some of their own resources to meeting the needs of their citizens. Such a requirement would, however, carry the risk that some areas might opt out of the program entirely, thereby reducing services to the economically disadvantaged.

One specific option might call for no contribution from the one-third most stressed jurisdictions, while requiring that other jurisdictions contribute one dollar for every four to nine dollars received from the federal government, with the fiscally strongest jurisdictions facing the largest matching requirements (see Appendix A-500-e). Applying this option based on states' fiscal capacities, federal spending for CETA could be reduced by nearly $1 billion during 1983-1987 without reducing services, if all jurisdictions chose to continue to participate. If some jurisdictions dropped out, federal savings would increase while services available locally would decline.

Providing GRS Funding Only to Fiscally Stressed Local Governments. A fourth example of further targeting federal aid would be to provide General Revenue Sharing funds only to fiscally stressed local governments. State governments were dropped from the GRS program in 1981 on the grounds that their fiscal condition no longer warranted general federal aid; a similar argument could be used to eliminate local governments with relatively strong fiscal balances. For example, GRS funding could be cut by a fixed proportion, such as 20 percent, and the remaining funds could be reserved for jurisdictions that had below-average tax bases and above-average tax efforts (see Appendix A-850-a). Or the remaining funds could be distributed to state governments, which could then be authorized to devise strategies for allocating funds among localities. Trimming the program by 20 percent would reduce federal outlays by $680 million in 1983 and by a total of $4.9 billion from 1983 to 1987.

Eliminating less-stressed localities would limit federal spending while ensuring that funds went to jurisdictions most in need of federal assistance. On the other hand, state and local governments have already experienced large reductions in other federal aid programs, and the current downturn in the economy has produced additional stress in many local budgets. Thus, eliminating some jurisdictions' GRS funds could exacerbate the fiscal strain they may already be experiencing.

Reducing the Federal Role in Selected Areas

A second general approach to reducing spending for education, employment and training, social services, and revenue sharing would be to reduce the federal role more generally in selected areas. This could be done either by cutting back programs judged to be ineffective or by withdrawing from policy arenas deemed to be more appropriately the domain of other levels of government or of the private sector. In the case of general reductions in federal aid, recipient jurisdictions or institutions could be partially compensated for funding cuts by being given greater discretion in the use of remaining funds. That, in turn, however, would lessen any assurance that the funds would be used to support national policy objectives.

Examples of ways to reduce the federal role in selected areas include: cutting back funding for the newly created elementary and secondary education block grant, and consolidating and reducing funding for campus-based student aid programs.

Reducing Elementary/Secondary Education Block Grant Funding. Historically, elementary and secondary education has been principally the responsibility of localities and states. This is reflected in the fact that the federal government currently provides only about 9 percent of all funds spent nationally on elementary and secondary education. Furthermore, the great majority of federal aid is allocated among jurisdictions in proportion to the presence of some target student population, such as handicapped persons or the educationally disadvantaged. The use of funds, in turn, is generally limited either to activities serving those students or to locally designed programs serving some federally defined policy goal. One notable exception to this pattern, however, is the Title II elementary and secondary education block grant, authorized under the 1981 reconciliation act and expected to distribute $470 million during 1982. Title II funds are allocated among states solely on the basis of total school-age population, and the money can be used to further the aims of any of the more than 20 programs consolidated into the block grant. These include such diverse activities as basic skills improvement, metric education, and emergency school aid (desegregation assistance).

One option for reducing the federal role in education would thus be to curtail funding under the Title II program (see Appendix A-500-a). Because the program is now only minimally targeted by purpose, it provides largely unrestricted fiscal assistance rather than supporting any specific federal policy interest in elementary and secondary education. Also, because Title II funds are allocated only on the basis of total school-age population and comprise less than one-half of one percent of all money spent by localities for elementary and secondary education, a limited cutback here would likely have little overall impact on school districts' finances. The impact would, however, be greater for fiscally stressed jurisdictions. Cutting funding for this program by 20 percent would reduce federal outlays by more than $400 million during the 1983-1987 period.

Reducing Funding for and Restructuring Campus-Based Student Aid Programs. The federal role in postsecondary education could be reduced without affecting the two largest student assistance programs--GSLs and Pell grants--by cutting funding for three campus-based student aid programs. In 1982, these programs--College Work Study, National Direct Student Loans, and Supplementary Educational Opportunity Grants--will provide about $1 billion to colleges and universities.

The federal role in postsecondary education could thus be curtailed without affecting the largest student assistance programs by reducing funding for the campus-based programs. The resulting cut in benefits might be diminished somewhat if a funding reduction was combined with a consolidation of these programs into a single campus-based student assistance block grant (see Appendix A-500-c). Under such an approach, institutions would be partially compensated for a reduction in aid by being given greater discretion in the use of funds. These institutions, however, already have some discretion to shift funds among present programs. Consolidating these three programs and reducing total funding by 25 percent would lower federal outlays by $40 million in 1983 and by nearly $1.2 billion through 1987.

CONCLUDING COMMENTS

Federal expenditures for education, employment and training, social services, and revenue sharing rose from $8.6 billion in 1970 to $36.5 billion in 1981. In the years immediately preceding the first session of the 97th Congress, however, growth under many of these programs slowed, and, in a small number of cases, absolute-dollar funding reductions were enacted. Budget decisions made during the first session of the 97th Congress cut 1982 spending under education, employment and training, and social services programs by 15 percent from the 1981 level but did not affect General Revenue Sharing.

Further budget reductions could be accomplished in these areas either by reducing aid for the least needy recipients or by reducing federal support for less effective programs or in areas deemed not primarily federal responsibilities. If all of the specific options outlined in this chapter were adopted, federal outlays would be reduced by more than $900 million in 1983. By 1987, annual savings would amount to $2.6 billion, or 7 percent of program costs.

CHAPTER IX HEALTH

The federal role in health involves assisting targeted groups to obtain access to medical care and supporting biomedical research. 1/ Most federal assistance is in the form of financing privately produced services. Medicare finances care for about 28 million aged and disabled persons, while Medicaid finances services for about 22 million persons with low incomes. 2/ In contrast, the Veterans Administration provides medical care, rather than financing, for veterans with service-connected medical problems or who are elderly or unable to afford care from other sources. A number of smaller programs provide assistance for targeted groups.

A much larger number of people benefit from tax subsidies for medical care, especially from the income tax exclusion for employer contributions to health benefit plans.

BUDGET HISTORY AND PROJECTIONS

Federal spending for health has grown rapidly during the past decade and is projected to continue to grow under current policies. The major factor behind this growth has been the ever-increasing rates of medical service provision in the United States, including, but not limited to, federally financed programs.

Federal health outlays totaled $76.4 billion in 1981, about 12 percent of the budget (see Table IX-1). The largest programs were Medicare and Medicaid, which accounted for $42.5 billion and $16.8 billion, respectively. Funding for health research support was $3.8 billion. In addition, tax subsidies for medical care led to a revenue loss of $25 billion in 1981.

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1. This chapter encompasses the health programs in budget function 550 as well as medical care for veterans (subfuction 703).

2. These two populations overlap somewhat.

TABLE IX-1. FEDERAL OUTLAYS FOR HEALTH (In billions of dollars)

Major Programs	Actual 1970	Actual 1981	Estimated 1982	Baseline Projection 1983	Baseline Projection 1987
Health a/					
Medicare	7.1	42.5	49.7	58.2	103.1
Medicaid	2.7	16.8	17.9	20.1	30.5
Other Health Services	1.3	4.5	3.9	3.7	4.6
Health Research	1.1	3.8	3.8	4.0	5.0
Other	0.9	1.8	1.8	1.7	1.8
Subtotal	13.1	69.4	77.1	87.6	145.0
Medical Care for Veterans b/	1.8	7.0	7.5	7.8	9.1
Pay Raises c/	--	--	--	0.4	2.5
Total	14.9	76.4	84.6	95.8	156.5

NOTE: Details may not add to totals because of rounding.

a. The outlays shown under Health include all those of budget function 550.

b. The outlays shown here include all those of subfunction 703.

c. See Table IV-1, footnote a, for distribution of pay raises. This table includes pay raises for all of function 550 and subfunction 703.

Historical Trends, 1970-1981

Outlays for health care grew dramatically during the 1970s, increasing from $14.9 billion in 1970 to $76.4 billion in 1981. Much of the increase is associated with growth in the Medicare and Medicaid programs.

Medicare. Medicare provides health insurance for 25 million persons aged 65 and over and 3 million disabled persons. It consists of two programs--the payroll-tax-financed Hospital Insurance

(HI) program and the voluntary Supplementary Medical Insurance (SMI) program that pays for physician services. The latter is financed by premiums (about one-quarter) and an appropriation from general revenues (about three-quarters).

Medicare outlays increased from $7.1 billion in 1970 to $42.5 billion in 1981, an average annual rate of increase of 17.6 percent. Much of the increase in outlays has come from the rising per capita spending on medical care. While the structure of Medicare benefits has changed little since the program's enactment, reimbursements per aged enrollee increased from $334 in 1970 to $1,409 in 1981. This increase, averaging 13.7 percent per year, exceeds by a substantial margin the 8.3 percent annual increase in medical prices during the period. The difference is explained by increasing rates of use of medical services. Rates of hospitalization have increased, and more and more services are delivered during a hospital stay. This phenomenon is not unique to Medicare, but reflects trends affecting the entire medical care system, although many think that Medicare's extensive coverage of hospital care and policy of reimbursement on the basis of cost have contributed to these trends. Growth in the population age 65 and over also contributed.

Expansion of eligibility in 1972 also contributed to growth in spending. 3/ Medicare coverage was extended to disabled persons who had received Social Security or Railroad Retirement benefits for at least 24 consecutive months and to persons suffering from end-stage renal disease. In 1981 reimbursements for care provided to these groups totaled $5.5 billion, or 13 percent of all Medicare reimbursements.

In 1972 the Congress enacted a number of measures designed to slow the rise in Medicare outlays by limiting the amounts of reimbursement to providers and reviewing the appropriateness of use of services. 4/ Savings from these provisions have been relatively modest compared with program outlays.

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3. Social Security Amendments of 1972 (P.L. 92-603).

4. Social Security Amendments of 1972 (P.L. 92-603). The more important provisions are Professional Standards Review Organizations (PSROs), which review the appropriateness of service use; the limits on hospital reimbursements; and the limiting of physicians' reasonable charges through an economic index.

Medicaid. The Medicaid program provides matching funds to states to finance medical care for low-income persons who are in families with dependent children or who are aged, blind, or disabled. Like Medicare, the cost of the program has grown rapidly, especially during its early years. Federal outlays increased from $2.7 billion in 1970 to $16.8 billion in 1981--or at a 9.1 percent annual rate after adjusting for inflation. Growth in the eligible population, and increases in per capita medical spending reflecting medical care system changes, were the principal causes. Increasing use of nursing homes by elderly persons has also been an important factor, especially in recent years. Nursing home and home health care now account for 44 percent of Medicaid costs.

Legislation has played a relatively minor role in Medicaid cost increases. The 1972 Social Security amendments increased eligibility by establishing the Supplemental Security Income (SSI) program, which provides cash assistance to low-income persons who are aged, blind, or disabled. In most states, SSI recipients are automatically eligible for Medicaid. In recent years, however, state governments have been restricting benefits and eligibility within the bounds permitted by federal law, slowing the growth in outlays to some extent.

Medical Care for Veterans and Other Health Care Services. Other federal programs, the largest of which is the Veterans Administration (VA) medical care system, deliver health services to specific populations. Outlays for veterans' medical care increased by 13.1 percent annually between 1970 and 1981, from $1.8 billion in 1970 to $7.0 billion in 1981. This increase is attributed primarily to an increase of 155 percent in the number of patients treated and to increases in the cost of providing medical care. Costs in the VA system were restrained somewhat by a 63 percent decrease in the median length of stay.

The Department of Health and Human Services (HHS) provides care to American Indians and, until recently, merchant seamen. In addition, a large number of categorical grant programs enable state and local governments and private agencies to provide various health services to low-income persons and to conduct public health activities such as immunizations. From 1970 to 1981, federal spending for the HHS delivery programs increased by 10 percent per year, reflecting inflation and growth in the number of programs.

Health Research. Nearly 90 percent of federal outlays for health research support biomedical research at the National Institutes of Health (NIH). The NIH sponsors both basic research on biological processes and research into the causes and treatment of specific diseases.

Increased federal involvement in biomedical research caused outlays to rise 12.5 percent annually between 1970 and 1981, or 4.3 percent after adjusting for inflation. During this period, research on certain specific diseases received disproportionate increases in funding because high priorities were set on finding cures for them. For example, between 1970 and 1980 the National Cancer Institute's budget increased by 450 percent. In recent years, as overall funding growth has slowed, increases in funding for specific illnesses have become more uniform.

The 1982 Budget Decisions

The 1982 budget decisions cut health programs less than other human resources programs, but the cuts were still of unprecedented magnitude. Health outlays in 1982 will be reduced by $2.8 billion, or 3.6 percent of what they would have been under current policies. 5/ Little attempt was made, however, to solve the underlying problem of rising per capita use of medical services. The most significant policy change was the consolidation of a number of categorical health programs into block grants to the states. These programs also absorbed the largest percentage reductions. Medical care for veterans and health research were affected least.

Nineteen categorical health programs were consolidated into four block grants to the states, and funding for them in 1982 was cut by 33 percent from current policy levels. The deepest cuts were experienced by programs incorporated into the Alcohol, Drug Abuse, and Mental Health block grant. The entitlement to medical care by merchant seamen was discontinued.

Federal grants to the states for Medicaid were cut 3 percent in 1982 (4 percent in 1983 and 4.5 percent in 1984) from what they otherwise would have been. The cuts will be reduced for those states with high unemployment, effective hospital cost control programs, documented fraud and abuse reductions, or very low rates of increase in Medicaid spending. States will also be allowed

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5. The baseline for cuts discussed in this section is the reconciliation baseline projection adopted by the Congress in May 1981. The 1982 funding levels for appropriated programs are those in the current continuing resolution (P.L. 97-92).

substantially more discretion in the areas of hospital reimbursement and coverage of the medically needy. Savings from Medicaid changes will total $0.9 billion in 1982, or 5.2 percent of spending under current policies.

In the Medicare program, cuts were made in both benefits and rates of hospital reimbursement. The amounts paid by the beneficiary before Medicare reimbursements begin (deductibles) were increased in both the hospital and the physician parts of the program. A number of benefit expansions enacted as part of the Omnibus Budget Reconciliation Act of 1980 (Public Law 96-499) were repealed as part of the 1981 reconciliation act. Hospital reimbursement was lowered by tightening the limits on per diem reimbursement for routine costs and reducing the size of extra payments intended to offset presumed higher nursing costs of Medicare patients. Excluding accounting savings from repeal of a change in the Medicare system of interim payments to hospitals, 1982 savings will total $0.7 billion, or 1.4 percent of spending under current policies.

Baseline Projections, 1983-1987

Federal spending on health is likely to continue to grow more rapidly than the rate of inflation, principally from rising medical care costs. Under current policies, outlays are expected to increase from $84.6 billion in 1982 to $156.5 billion in 1987, an annual increase of 13.1 percent.

Medicare outlays will increase the most rapidly, at an annual rate of 15.7 percent during this period. In addition to rising medical care costs, the aging of the population will be a factor.

Medicaid spending is expected to grow much less rapidly than that for Medicare, but still more rapidly than the general rate of inflation. The eligible population is projected to decline somewhat, although increasing use of long-term care, caused by the aging of the population, will work in the opposite direction. Medicaid spending is also affected by rising medical care costs.

Outlays for veterans' medical care will grow rapidly because of demographic trends. The number of veterans over age 65 will more than double in the decade of the 1980s. Aged veterans are particularly heavy users of the VA medical care system.

BUDGET STRATEGIES

In developing budget reduction strategies for health, the basic federal role--financial assistance to individuals to obtain care in the private medical system--is not in question. Few have suggested that such assistance is not an appropriate federal responsibility. Instead, changes are being sought that would reduce the budgetary costs of continuing this role.

This chapter examines two basic budget strategies for health. One would involve a direct reduction of outlays through shifting responsibility from the federal government to individuals and businesses. The other would involve actions to reduce the cost of medical care, which would indirectly reduce federal outlays. Many specific budget reduction options encompass both strategies--that is, by shifting responsibility in certain ways they would release market forces that would contain health costs.

First, major opportunities for shifting responsibility exist in the Medicare and Medicaid programs and in the tax provisions that relate to medical care. Responsibility for Medicare and Medicaid financing could be shifted to beneficiaries, providers of medical services, to other levels of government, or to a limited extent, employers. 6/ Beneficiaries could be required to pay more, providers could be paid less, employment-based coverage could be required to pay for services that are also covered by Medicare, and the federal government could pay a lower percentage of the costs of Medicaid. Tax benefits could be reduced for those obtaining health insurance through employers or for those using the medical expense deduction.

Second, the federal government has two broad options for reducing medical care costs, which in turn would reduce Medicare and Medicaid outlays and the revenue loss from health care provisions in the tax code. It could take steps to make greater use of market forces in the production and distribution of medical care,

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6. Opportunities to shift responsibility to employers are limited, because few persons receiving benefits from these programs are employed. Very few Medicare beneficiaries are employed full time--and part-time employees are often not covered by the firms' policies. Medicaid already does not pay for services covered by a private insurance policy.

or it could add to the economic regulation of medical care. Either option could include a shift of responsibility away from the federal government as well.

Increased reliance on the market means getting the patient to accept more responsibility for medical care costs. The patient might be required to accept increased cost sharing or to choose among alternative health care delivery systems such as Health Maintenance Organizations (HMOs). In either case, the patient would be given an incentive to reduce the use of services, which in turn would place downward pressure on prices.

Among regulatory options, the most promising is control over hospital revenues. The strategy behind such regulation is to provide hospitals with an economic constraint, one that they do not currently get from the market because third parties, rather than patients, pay for most hospital care. Whether limitations on Medicare and Medicaid reimbursements alone would suffice to provide such a constraint, or whether revenues from all payers must be controlled, is a subject of extensive debate. The federal government could either regulate hospital revenues itself or encourage states to do it. 7/

Shifting Responsibility to Beneficiaries

Requiring beneficiaries to pay more of their medical care costs could lead to substantial budget savings, but the magnitude of such a shift would be constrained by the fact that many beneficiaries cannot afford additional out-of-pocket expenses. Medicaid recipients all have very low incomes. Some Medicare beneficiaries are better off, however, and could pay somewhat more out-of-pocket for medical services.

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7. Contrary to common belief, the federal experience with economic regulation of medical care has been very limited. Except for the period of wage and price controls during the early 1970s, neither physicians' fees nor hospital rates have been regulated at the federal level. Federal law (P.L. 93-641) does require states to conduct certificate-of-need review of major hospital capital projects, but the deadline for compliance is still in the future.

One way of dealing with this constraint would be to exempt those with the lowest incomes from the requirements of higher out-of-pocket spending. This would keep reductions in access to medical care to a minimum and would concentrate burdens on those most able to bear them. A means test of this sort for Medicare services would encounter opposition, however, on the grounds that Medicare is a social insurance program. Another consideration would be the administrative costs involved in assessing financial need.

Among the different ways of reducing outlays by shifting responsibility to beneficiaries, some would also stimulate market forces that would act to contain medical costs. In general, requiring beneficiaries to pay more for the services they use would tend to contain medical costs, while raising the premiums they pay for coverage would not.

Alter the Pattern of Hospital Coinsurance under Medicare. Under current law, beneficiaries pay a deductible amount equal to the estimated average cost of one day's hospitalization, but have no other cost sharing until the sixty-first day of hospitalization during a spell of illness, at which point coinsurance begins. Such extensive coverage does not provide much incentive to limit hospital use.

Beneficiaries could be required to pay 10 percent of the cost of the current deductible for the second through thirty-first day in a calendar year--about $26 per day in 1982 (see Appendix A-550-b). Some of the savings from this coinsurance charge could be used to limit patient liability for hospitalization by expanding Medicare coverage to all hospital charges beyond the first 31 days of hospitalization in a calendar year. The net reduction in federal outlays would be $1.1 billion in 1983 and $7.4 billion over the 1983-1987 period. State Medicaid outlays would increase, however, since Medicaid would pay the additional coinsurance for those Medicare beneficiaries also eligible for Medicaid.

The proposal would reduce rates of use of hospital services for those not receiving Medicaid or not covered by private supplemental insurance. This in turn would pressure hospitals to contain costs. While the proposal would improve protection against the risks of very large expenses, some beneficiaries with low incomes might be adversely affected.

If additional budget reductions in the Medicare program were sought, the coinsurance rate could be increased further. In that case, consideration might be given to limiting the additional cost sharing to those beneficiaries with relatively high incomes--in effect, partially means testing Medicare benefits.

Tax Private Insurance that Supplements Medicare. Over half of all Medicare beneficiaries purchase (or receive from employers) private coverage to supplement Medicare. Many of these plans pay the deductibles and coinsurance required of Medicare beneficiaries, so that in effect they have full coverage for hospital and physician services.

Medicare implicitly subsidizes these supplemental policies, because it pays a large portion of the costs of additional use of services that they generate. Adding supplemental benefits to Medicare results in about a 7 to 10 percent increase in service use--and Medicare pays most of these costs (for example, 80 percent of physicians' reasonable charges).

By taxing supplemental plans, the federal government could recoup this unintended subsidy to those purchasing supplemental coverage (see Appendix B-550-e). Federal savings would come both from tax collections and from reduced service use by those deciding to discontinue supplemental coverage; savings would amount to $2.5 billion in 1983 and $17.7 billion over the 1983-1987 period.

This option would, like the coinsurance option, reduce the use of medical services, but its distributional impact would be different in that it would affect only those Medicare beneficiaries with supplemental coverage. Such persons would tend not to be the beneficiaries with the lowest incomes, who would be most adversely affected by the coinsurance option.

Increase Medicare Part B Premiums. When originally enacted, Part B of Medicare--which covers physicians' services--was to obtain 50 percent of its financing through premiums paid by the beneficiaries. In 1972, percentage increases in premiums were limited to the cost-of-living adjustment for Social Security benefits. With medical care costs rising rapidly, the proportion of Part B expenses financed by premiums declined to 25 percent in 1981, and will continue to fall.

Raising the percentage to 30 percent would increase receipts from premiums (and reduce required transfers from general revenues) by $1.0 billion in 1983 and $11 billion over the 1983-1987 period (see Appendix B-550-d). Under such an option, premiums for 1982-1983 would increase to $14.90 per month, an increase of $2.70 per month from the level projected under current law. In contrast to the previous two options, raising premiums would have little effect on medical care costs.

Since the poorest Medicare beneficiaries are also covered by Medicaid, which usually pays Part B premiums on their behalf, this option would not affect them. It could be burdensome to those whose incomes are only slightly higher than SSI eligibility levels, however. States' responsibility for the premiums of Medicaid recipients would increase their outlays by roughly 8 percent of the amount saved by the federal government.

Shifting Responsibility to Medical Providers

The long-term potential for budget savings from reducing payments to providers would depend upon the extent to which the providers were given opportunities to avoid reductions in net income by lowering their costs. If the design of the cut did not permit such opportunities, risks of a significant reduction in access to care by the beneficiaries would limit the extent to which reimbursements could be cut.

In hospital reimbursement, Medicare and Medicaid already pay substantially less than other payers. Investment bankers report that hospitals with large Medicare and Medicaid caseloads tend to be shunned by lenders. Further reimbursement reductions could impair the ability of these hospitals to modernize their plant and equipment, or even to continue to operate. On the other hand, options such as prospective reimbursement of hospitals could ultimately lead to large budget savings without injuring hospitals if they were successful in spurring hospitals to reduce costs.

In physician reimbursement, on the other hand, a reduction in rates in Medicare would be to some extent equivalent to a reduction in benefits, since many physicians would compensate by requiring patients to pay more. In Medicaid, where physicians must accept the program's reimbursement as payment in full, physician participation would decline further.

Expand Medicare Hospital Routine Cost Limits to Include Ancillary Services. Currently, Medicare reimbursements for routine costs (nursing and room and board services) are limited to 108 percent of mean per diem costs in groups of similar hospitals. Such limits give high-cost hospitals incentives to reduce costs. But most analysts feel that the nub of the hospital problem lies in ancillary services such as laboratory tests and X-rays, a component of costs to which current reimbursement limits do not apply.

Limiting reimbursement to 110 percent of the group mean for total operating costs (adjusted for diagnostic mix) would give high-cost hospitals incentives to contain ancillary as well as routine costs (see Appendix A-550-c). Federal savings would be modest in 1983 because of start-up delays, but would total $5 billion over the 1983-1987 period.

This option would reduce hospital costs to some extent, although some of the reimbursement reduction would be borne by other payers or by the hospital itself. Some hospitals would find it much easier to make up for the reimbursement reduction by raising charges to private patients rather than reducing costs. Those facing relatively large reimbursement reductions would not be able to reduce costs by as much, at least initially.

Give Incentives to States for Hospital Cost Containment. Currently, six states have mandatory programs that limit hospital rates or revenue. As a group, these programs have been quite successful in slowing the rise in hospital costs, although some observers contend that the savings have come at the expense of the quality of care. The federal government has benefited substantially from the success of these programs, through lower Medicare and Medicaid reimbursements to hospitals.

Offering the states a share of the savings the federal government realizes from their programs could induce additional states to pursue such efforts, and ultimately further reduce federal outlays for Medicare and Medicaid (see Appendix A-550-d). While estimates of savings depend upon the number of states induced to develop programs, giving states one-third of the Medicare savings could reduce federal outlays by $1.5 billion over the 1983-1987 period. States initiating programs would gain substantial amounts through both the incentive payments and Medicaid savings.

Shifting Responsibility to Other Levels of Government

The federal government in 1982 will pay about 55 percent of the cost of Medicaid through matching grants to the states. This rate was reduced from 56 percent by the 1981 reconciliation act. An argument against shifting further responsibility in this direction is that the state and local governments are not in a position to absorb significant additional burdens. A significant shift could seriously restrict states in their abilities to provide essential services without raising their tax rates, or force them to impose major cuts in Medicaid eligibility and benefits. One option with some potential would be to cap federal grants to states for Medicaid for long-term care.

Cap Medicaid Grants for Long-Term Care. Medicaid expenditures for long-term care have grown very rapidly, and now represent 44 percent of Medicaid expenditures. A formula-determined ceiling on federal grants for long-term care expenditures, coupled with increased discretion for states to manage the delivery of long-term care services, would save federal dollars--about $3.4 billion over 1983-1987--and could lead states to reduce health costs (see Appendix A-550-a).

The extent to which such a change in funding would reduce health costs rather than merely shift responsibility to the states would depend upon states' potential to reduce their Medicaid outlays for long-term care, given additional discretion and incentives. While some are enthusiastic about the prospects for economizing through substituting home-based services for nursing home care, an important obstacle to outlay reduction is the likelihood that some of the beneficiaries of increased funding for home-based services would not have been institutionalized in any event. In addition, nursing home capacity constraints in some states are such that beds vacated by patients newly treated at home would be filled by others on a waiting list. If states were not able to reduce their long-term care outlays under Medicaid, then this option would become primarily one of shifting responsibility.

Shifting Responsibility to Taxpayers

In contrast to the Medicare and Medicaid programs, whose benefits are targeted toward the elderly and the poor, tax provisions affecting spending for medical care are not specifically targeted; they benefit middle- and upper-income persons most. The following options would shift some responsibility to taxpayers. The first would also work to contain medical care costs by increasing cost sharing and enrollment in HMOs.

Tax Some Employer-Paid Health Insurance. Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce federal revenues by about $25 billion in 1983. One proposal for limiting the present exclusion would treat as taxable income any portion of employer contributions exceeding $150 a month for family coverage and $60 a month for individual coverage in 1983, with the amount indexed thereafter to medical care prices (see Appendix B-550-b). The proposal would increase revenues by $2.6 billion in 1983 and $27 billion over five years.

Limiting the exclusion would reduce the comprehensiveness of employer-provided health insurance benefits. By limiting the special treatment of employer contributions, the incentive to shift employee compensation from cash to health insurance would be reduced. Less health insurance would induce employees to economize on their use of health services, which in turn would slow medical cost increases.

If larger revenue increases were desired, either the ceiling could be lowered, or a smaller inflation adjustment used. Eliminating the exclusion altogether would raise much larger amounts of revenue--$18 billion in 1983 for example.

Tighten the Medical Expense Deduction. The 35 percent of taxpayers who itemize may claim as deductions all out-of-pocket medical expenses that in total exceed 3 percent of adjusted gross income (AGI). Raising the threshold to 15 percent of AGI would add $0.4 billion to revenues in 1983 and $14 billion over the next five years (see Appendix B-550-a).

The argument for tightening the deduction is that it does little to increase access to basic medical care. In contrast to 1942, when the provision was first introduced into the tax code, most persons today have health insurance to finance medical care. For those who do not, and whose incomes are insufficient to purchase medical care, the deduction gives only minimal assistance.

CONCLUDING COMMENTS

Federal spending for health has increased rapidly in recent years, primarily because of developments in the medical care system. That system now delivers more medical services per person than in earlier years, and at higher costs. Since federal programs serve primarily to finance people's access to medical care, budget outlays have risen correspondingly.

Both of the budget reduction strategies discussed in this chapter would maintain the basic federal role in financing medical care for the needy. The first strategy would enable the federal government to shift some of the financial responsibility to beneficiaries, medical care providers, other levels of goverment, or taxpayers who benefit from tax expenditures for medical care. The other strategy would work to slow the rise in medical costs, either by stimulating market forces or through economic regulation of medical care--steps that hold the greatest promise of reducing federal spending on health in the long run. Some of the options discussed have important elements of both strategies.

CHAPTER X. INCOME SECURITY

Federal income security programs, mostly under budget function 600 and a few under function 700, provide assistance to broad segments of the population. Most such aid takes the form of social insurance for retirement, disability, and unemployment. Social Security, the largest such program, alone accounted for more than one-fifth of the total U.S. budget in 1981. Other social insurance programs under income security include veterans' compensation, retirement and disability benefits for federal employees, compensation for victims of black lung disease, and a portion of unemployment compensation.

Besides social insurance, income security programs provide "means-tested" benefits to low-income families. Some means-tested benefits are directed toward specific consumption activities through the Food Stamp, energy assistance, and various child nutrition and housing assistance programs. Means-tested cash assistance programs are Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), veterans' pensions, and the Earned Income Tax Credit.

Although not part of the income security category, many other provisions in the tax code--such as the extra personal exemption for the aged and blind--also extend income support to individuals. Possible changes in these tax provisions are discussed in Chapter XII.

BUDGET HISTORY AND PROJECTIONS

Federal spending for income security has grown dramatically over the last decade. Starting from 25 percent of total federal outlays in 1970, income security programs now constitute one-third of all federal spending--about $238 billion in 1981. The growth of some of these programs is summarized in Table X-1. The food and housing assistance programs increased at the most rapid rate during the 1970s, although together their outlays totaled less than $23 billion in 1981. Social Security, the most important contributor to growth in dollar terms, increased more slowly than the food and housing assistance programs although at a faster rate than either AFDC or SSI.

TABLE X-1. FEDERAL OUTLAYS FOR INCOME SECURITY PROGRAMS (In billions of dollars)

Major Programs	Actual		Estimated	Baseline Projection	
	1970	1981	1982	1983	1987
Social Insurance					
Social Security retirement	27.3	122.3	139.3	153.6	214.2
Social Security disability	3.0	17.3	18.8	20.0	23.5
Veterans' pensions	2.3	3.8	3.6	3.5	3.5
Veterans' disability compensation	3.0	8.5	9.5	10.4	14.0
Civil Service retirement a/	2.7	17.7	19.8	22.0	31.6
Means-Tested Programs					
AFDC	2.2	8.5	8.1	8.3	9.9
SSI	1.9 b/	7.2	8.0	9.1	10.6
Food Stamps	0.6	11.3	11.5	12.5	15.7
Other nutrition programs	0.6	5.0	4.6	4.9	6.6
Housing assistance programs	0.5	6.8	8.3	9.8	16.0
Other Social Insurance and Means-Tested Programs c/	4.2	29.6	34.5	32.5	33.3
Pay Raises d/	---	---	---	0.1	0.3
Total	48.3	238.0	266.0	286.7	379.2

a. Civil Service retirement is discussed in Chapter XI.

b. Based on total federal outlays for Aid to the Blind, Aid to the Aged, and Aid to the Permanently and Totally Disabled.

c. This category includes smaller income security programs such as black lung disability, the federal share of unemployment insurance, and the Earned Income Tax Credit.

d. See Table IV-1, footnote a, for distribution of pay raises.

Historical Trends, 1970-1981

Economic factors are particularly critical in explaining the rise in income security outlays over the last decade. The combination of inflation and program indexation (that is, automatic cost-of-living adjustments, or COLAs) brought about much of the growth. Indexation translates increases in consumer prices into higher nominal benefit levels. 1/ In the income security area, these economic forces have had an especially great influence on the Social Security program, putting extreme pressure on the trust funds that finance the system. In addition to inflation, high unemployment rates contributed to outlay growth.

Other factors explaining the trend in income security outlays are legislative and demographic changes. Legislative actions prompted high growth rates of outlays through expanded coverage and benefits under existing programs and the introduction of new programs. Also, since many income security programs are "entitlements," with eligibility and benefit amounts determined according to fixed provisions of law, demographic changes have increased the number of persons qualifying for benefits during the 1970s.

Economic Factors. High rates of inflation contribute to growth in income security through the indexation of benefits. Most COLAs were introduced by the early 1970s, although their impact became more important as rates of inflation increased late in the decade. Social Security, railroad retirement, federal civilian and military retirement, SSI, veterans' pensions, and food stamps and most child nutrition benefits are currently adjusted automatically for inflation; much of these programs' growth can be attributed to this indexing. Together, these programs account for nearly 80 percent of income security outlays.

In addition, since nominal wages tend to rise steeply during periods of inflation, so do retirement, disability, and unemployment compensation benefits based on earnings. This has been particularly important for Social Security. Finally, to maintain real benefit levels, benefits in unindexed programs are often increased on an ad hoc basis in periods of inflation.

Unemployment rates also critically affect the costs of many income security programs. Increases in the level of unemployment raise both participation in unemployment insurance and the duration of the benefit period. To a lesser extent, high unemployment rates

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1. Unless otherwise specified, all amounts are shown in current (nominal) dollars. Consequently, some nominal increases in benefits may actually represent a decline in purchasing power (as measured by "real" changes in benefits). If benefits were perfectly indexed for inflation, real benefits would remain constant.

also increase participation in food stamps and AFDC, and may raise enrollment in disability and retirement programs (including Social Security). In the 1970s, unemployment averaged 6.2 percent a year, whereas the annual average in the 1960s was 4.8 percent.

Legislative Changes. A number of legislative changes have also contributed to escalation in program costs. During the 1970s, the Congress increased benefits, liberalized eligibility standards, and introduced a number of new means-tested programs.

Through the 1960s and early 1970s, rules governing eligibility and benefit levels for social insurance programs were liberalized, resulting in expanded participation. For example, the easing of administrative rules under the Social Security disability program probably contributed to the growth of disabled workers' enrollment from 1.4 million in 1970 to 2.9 million in 1979. Moreover, in 1972, the Congress raised Social Security benefit levels substantially. The increases from this change more than compensated beneficiaries for changes in prices since the previous increase, which occurred in January 1971.

During the 1970s, several new means-tested programs were enacted. In 1974, the federal SSI program replaced Old Age Assistance, Aid to the Blind, and Aid to the Permanently and Totally Disabled--programs with costs shared by the states. Although the categories of persons eligible for assistance did not expand under SSI, the federal government accepted responsibility for providing a standard, nationwide benefit level, resulting in larger benefits for many participants and an easing of states' welfare burdens.

Although food assistance programs have existed in some form for more than five decades, major administrative modifications in 1969 effectively created a new Food Stamp program that was then incorporated into one nationwide program in the mid-1970s. Partly because of the relaxation of certain regulations (such as elimination of the purchase requirement), the Food Stamp program has expanded substantially. The number of food-assistance beneficiaries rose from 14.3 million in 1971 to 21.8 million by 1980.

Another new income security program, the Earned Income Tax Credit, aids low-income families either by reducing the taxes they owe or by offering direct payments to those with no tax liability. The direct-payment portion of the credit is considered part of the income security function. This program provides benefits for the working poor with dependent children, a group with little other federal assistance.

Demographic Shifts. The aging of the population has contributed significantly to the growth in income security outlays over the past decade. Between 1970 and 1980, the number of persons aged 65 or older grew by 28 percent, compared to only a 10 percent increase in the number of persons under 65. Outlays for Social Security and SSI are sensitive to the greater number of elderly. In addition, the trend toward early retirement also augmented Social Security outlays over this period.

Changes in the structure of the American family have expanded the roles of other income security programs. Rising divorce rates and numbers of single mothers led to an increase in the number of households headed by women. Such families have lower-than-average incomes, which makes them more likely to be eligible for AFDC. The proportion of families receiving AFDC benefits increased over the decade, from 3.7 percent of all U.S. families in 1970 to 6.5 percent in 1980.

The 1982 Budget Decisions

The Congress' 1982 budget decisions will reduce income security outlays by approximately $10 billion from the original CBO baseline estimate for 1982. 2/ Although this will lower spending for nearly every income security program, the means-tested programs will be affected to a greater extent than social insurance. The AFDC, Food Stamp, and child nutrition programs will undergo large reductions, while relatively small cuts were made in SSI and veterans' programs. Social Security retirement and disability will account for only 17 percent of outlay savings, although this program will represent an estimated 59.4 percent of all income security outlays in 1982.

Budget reductions in the social insurance area focused on relatively small adjustments in programs. The largest change (in dollar terms) will phase out the postsecondary student benefit program funded by Social Security. Current student beneficiaries will face substantial reductions in payment levels and anyone who is not a full-time postsecondary student before May 1982 cannot qualify for the program at all. Another important change in Social Security is the elimination of the Social Security minimum benefit

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2. The baseline for cuts discussed in this section is the reconciliation baseline projection adopted by the Congress in May 1981.

for virtually all new recipients. Other reductions, such as the imposition of a so-called "megacap" on new public disability awards, have been instituted to reduce duplicate benefits.

Most of the changes in income security affect the means-tested programs. A large portion of savings will be achieved simply by reducing the level of benefits or services provided. More stringent income and other eligibility standards will be imposed for AFDC, food stamps, and child nutrition, particularly limiting participation by the working poor and persons just below the poverty line. For example, the AFDC program will now reduce benefits by $1 for every $1 earned after four months of employment, which will affect both levels of benefit payments and numbers of beneficiaries. Administrative adjustments such as retrospective monthly accounting for the AFDC, SSI, and Food Stamp programs will contribute to ensuring that benefits change quickly in response to changes in participants' incomes.

Overall, the federal share of AFDC benefits was cut by $659 million and the food and nutrition assistance programs--including food stamps and child nutrition--were reduced by about $3.2 billion. Funding for low-income energy assistance has been reduced by $495 million, which is a cut of 22 percent compared to the original CBO baseline. Housing assistance was cut back by reducing the number of additional subsidy commitments funded for 1982 and by raising the rent payments of tenants in federally subsidized housing from 25 to 30 percent of household income over the next five years (see also Chapter VII).

Baseline Projections, 1983-1987

By 1987, income security outlays are projected to reach $378.9 billion--a 32.2 percent increase from 1983. [3] Much of this growth will arise from the COLAs, which automatically raise benefit levels for many of the income security programs. Indeed, several of the programs are projected to experience declines in the number of beneficiaries over the five-year period.

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[3] This figure includes all of function 600 and veterans' pensions and compensation from function 700. The figures in this section do not, however, include estimated pay increases for the out-years (1983-1987), which are projected to total $0.3 billion in 1987, since these pay raises have not been allocated across separate programs.

The Social Security old age, survivor, and disability programs are projected to expand rapidly through 1987, increasing both in dollar terms--to $237.6 billion--and as a proportion of all income security programs. Social Security's share of income security is projected to rise from 60.6 percent in 1983 to 62.7 percent in 1987. The retirement portion is projected to grow by 39.4 percent between 1983 and 1987--a faster pace than the 17.6 percent rate for Social Security disability. Much of this estimated growth will arise from the COLA adjustments, although the expansion in the number of older Americans and higher average wages of new retirees will continue to contribute to increases in Social Security outlays. The disability caseload, however, is expected to decline.

Only federal housing assistance programs are projected to increase at a more rapid rate than Social Security. These programs are projected to account for $16 billion in federal outlays by 1987. This figure assumes that additional households will receive aid each year, increasing at the same rate as the growth in recipient households in 1982. Veterans' compensation and nutrition programs other than food stamps are also projected to rise substantially over the next five years, each increasing by about 35 percent.

Rates of growth are projected to be much slower for the means-tested cash assistance programs. It is estimated that SSI benefits will rise to $10.6 billion--a 16.5 percent increase. According to this projection, benefits per capita will rise more rapidly but will be offset by a decline in the number of beneficiaries. Similarly, veterans' pensions are expected to remain constant in nominal terms at $3.5 billion, partly as a result of more restrictive eligibility standards for new cases. AFDC's relatively low projected growth rate through 1987 reflects fairly stable numbers of participants and per capita benefit increases that will lag behind those programs with automatic COLAs.

BUDGET STRATEGIES

In view of the magnitude of this budget function, income security seems certain to be a prime area for future benefit reductions. Because of the size of the social insurance portion, the options described here focus on Social Security and veterans' programs. Potential changes in the means-tested programs are also discussed and compared. The options detailed here illustrate some of the issues and tradeoffs that might arise from additional budget reductions; they do not, however, represent an exhaustive enumeration of possible cuts.

In evaluating examples of specific strategies for reductions in the income security area, several broad issues are appropriate to consider, specifically:

- The differences among programs with regard to state and local government responsibility;
- The interrelationships among income security programs; and
- The tradeoffs between budget reductions and desirable incentives for recipients.

Income security programs differ considerably in terms of federal, state, and local government responsibilities. Social Security and the veterans' programs provide uniform national coverage and are usually considered outside the bounds of state and local responsibilities. State and local participation is of concern for the means-tested programs, however, since the states currently administer--and in some cases, share the costs of--several of these programs. A shifting of responsibility through unrestricted block grants for some means-tested programs might reduce paperwork at the federal level and enhance states' flexibility in tailoring programs to meet local needs. These grants would not yield major federal outlay savings, however, unless federal support for benefits were concurrently reduced. Such reductions would disproportionately affect areas with greater percentages of low-income families--areas likely to have lower fiscal capacity as well--and might result in even greater disparities in benefit levels among states than currently exist.

Achieving major reductions in outlays is complicated by the interrelationships among many of the income security programs. Any savings from benefit reductions in one program may be partially offset elsewhere. For example, a reduction in Social Security benefits may increase eligibility and payments to the elderly from SSI. Moreover, in this particular case, new SSI participants are likely to become eligible for Medicaid and food stamps as well. Additional cuts in AFDC benefits would in most cases generate offsets of more than 50 percent through increased federal outlays for food stamps and housing assistance. On the other hand, some changes may lead to a compounding of reductions to beneficiaries, where total payments may fall more rapidly than they would appear to if only one program is considered. For instance, some earners who participate in both AFDC and Medicaid are subject, after four months of employment, to a loss of benefits that would considerably exceed their total earnings.

Important tradeoffs between budget reductions and desirable incentives for beneficiaries are likely to occur. For example, evidence suggests that the behavior of families and individuals is sensitive to the amount of earned income they are allowed to keep while participating in income security programs. If the rules are very restrictive, savings in outlays must be balanced against the disincentives for beneficiaries to work. Moreover, if the penalties are too severe, outlays could actually increase as fewer participants are employed. In such a case, short-run savings would occur at the expense of both long-run budget savings and work incentives.

Changes in Social Security

During 1982, 59.4 percent of all income security outlays will be devoted to Social Security payments. Consequently, in order to achieve major reductions in income security, changes in Social Security may be necessary.

The short-term financial crisis facing the Social Security system gives particular urgency to consideration of cuts in this program. According to CBO's most recent projection, the combined balance in the three Social Security trust funds may fall to a level that is too low to ensure timely payment of all benefits. Specifically, CBO projects that, unless corrective measures are taken, Social Security trust fund levels could drop to 13.4 percent of annual outlays by the end of fiscal year 1983, and they could be as low as 7.6 percent by the end of 1984. Though there is no consensus about an acceptable minimum level of trust fund reserves, a year-end figure of 12 percent of the coming year's anticipated outlays falls roughly in the middle of the range of levels that various analysts regard as adequate to guarantee that all benefits can be paid on time. In fact, if economic conditions are more adverse than are now anticipated, the depletion of the trust funds could occur even sooner. Changes in either the benefits or revenues will be required within the next two years to guarantee uninterrupted payments to beneficiaries.

A wide range of policy options could generate savings in Social Security. Very large and prompt savings could come from a change in the Social Security COLA. Other outlay savings could arise from reducing or eliminating benefits to particular groups or from changing the retirement age. Because Social Security is funded directly by a payroll tax, the system's financial position could also be improved by changes in the tax structure or the characteristics of the population covered. Payroll taxes could be raised, or additional workers--such as federal employees--could be added to the system to increase revenues (see Appendix B-600-d). Finally, some portion of Social Security benefits could be taxed and the proceeds allocated to the trust funds (see Appendix B-600-c).

Some of these options would affect all beneficiaries, while others would reduce benefits for particular groups of current or future beneficiaries. Limiting reductions to future Social Security recipients would ensure that current beneficiaries lose no real benefits. On the other hand, current retirees are projected to receive much higher rates of return on their contributions than are future beneficiaries. A single male worker retiring at age 65 in 1980 who had earned the average wage since age 22 could expect to receive about 5.6 times as much in lifetime benefits as taxes paid (based only on employee contributions). Under current law, that proportion will drop to 2.2 for a similar worker retiring in the year 2000. Moreover, confining reductions in Social Security benefits to future retirees would postpone outlay savings because few persons would be affected initially. Options that involve a large number of beneficiaries could achieve the same total savings with less sacrifice by each affected recipient.

Another important issue in designing Social Security reductions is the speed of implementation and the tradeoff between the magnitude of short-run savings and the ability of beneficiaries to adjust to the changes. The sooner changes are implemented, the larger the initial savings and the greater the contribution to solving the financial problems of the trust funds. These advantages must, however, be weighed against the ability of Social Security recipients to respond to sudden, unexpected changes in the program. For example, the tradeoffs for options affecting retirement age are particularly acute. Since many workers plan for retirement long in advance, an extended phase-in period would be necessary to allow people to adjust their financial plans.

Changing the Indexing Methods. A large reduction in outlays in the short run could be generated by some change in the Social Security COLA, which is used to alter benefits each July 1. Such a change would affect almost all beneficiaries by the same proportional amount and would require no phase-in period. 4/ Consequently, current retirees, who have relatively high rates of return to their contributions, would be included in the benefit modifications. Moreover, a reduction in the COLA, with its immediate impact on outlays, would be particularly effective in alleviating the projected crisis in the trust funds.

Automatic cost-of-living adjustments based on the CPI have led to much of the growth in Social Security benefits since 1975. Moreover, many observers believe that Social Security benefits have been overindexed in the recent past, because of a now-corrected technical flaw in the benefit formula and the way in which the CPI treats homeownership costs. 5/ If so, Social Security beneficiaries have received increasing real benefits at a time when other sources of income have not kept pace with inflation. For example, prices have risen faster than average wages over the last three years, so that workers' real earnings have fallen while Social Security benefits have been fully protected (and perhaps overprotected) against inflation.

On the other hand, large reductions in the COLA could create substantial hardships for those among the elderly with relatively low benefits and little other income. The oldest among the beneficiaries rely heavily on Social Security and have little ability to adjust to such changes. (SSI benefits could offset this loss for some recipients, unless that program were also subjected to COLA restrictions.)

A number of approaches could be used to alter the degree to which benefits are indexed. Such changes include:

o Reducing the COLA to two-thirds of the CPI;

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4. Only student beneficiaries, whose benefits are no longer indexed and are being phased out, would not be affected.

5. Critics argue that the CPI currently uses a flawed treatment of homeownership. Rising building costs and record mortgage interest rates are cited as major reasons for the overstatement of inflation. Beginning in 1983, the CPI will use rental costs for the housing component. Over the long run, this may or may not affect the rate of change in the CPI and hence the cost-of-living adjustments.

- Delaying COLAs by three months; and
- Changing the indexing of the "bend points" in the benefit computation formula over the next five years.

The first two approaches could be instituted immediately, yielding large reductions in outlays through 1987 (see Appendix A-600-c and A-600-b). The third (see Appendix A-600-f) would reduce benefits by changing the formula through which average indexed monthly earnings (AIME) are translated into a primary insurance amount. This option, which would affect only new beneficiaries, would be phased in over a five-year period.

The first approach would automatically increase benefits in July of each year by only two-thirds of the rise in the CPI. Nominal benefits to all recipients would rise each year (if inflation continues) but by a proportionately smaller amount than under the current adjustment formula. In times of less budget stringency, the Congress could, at its discretion, increase the adjustment. Outlay savings could total $76 billion by 1987 if the reduction starts with the July 1982 COLA, but only if the Congress avoids discretionary supplements above the two-thirds limit. This very large potential saving illustrates the impact of indexing on the growth of Social Security outlays.

As a second example, a permanent delay in the COLA from July 1 to October 1 would implicitly reduce benefits to Social Security recipients for three months each year as compared to current practice. As benefits are now projected, this would result in outlay reductions of more than $16 billion over the next five years. Again, all beneficiaries would be affected.

Finally, a less direct indexing adjustment would change the "bend points" of the benefit computation formula. Using a three-bracket formula, benefits are computed as percentages of AIME. These percentages decline at discrete bend points, which are currently indexed to rise over time with the increase in average covered wages in order to keep replacement rates roughly constant. If the adjustment were constrained to rise at only 50 percent of the wage increase, benefits for new retirees would fall as a proportion of their past earnings, as compared to the current formula. This option would differ from the other two changes, in that it would affect only new retirees, with the largest relative declines experienced by persons with the highest covered earnings. Savings from this approach would be small in the beginning but would grow in later years--in fact, this change alone could offset most of the projected long-term shortfall in the Social Security trust funds. Through 1987, five-year cumulative savings would total $3.6 billion.

Reducing or Eliminating Benefits. Options for reducing or eliminating Social Security benefits would affect a smaller proportion of all beneficiaries than would the indexing options. The two approaches discussed here affect auxiliary benefits rather than basic coverage for retirement or disability. The justification for these modifications is to improve the targeting of Social Security benefits to people who are most in need. At present, Social Security benefits are available to the wealthiest people in the United States as well as the poorest. Consequently, changes in auxiliary benefits may be able to reduce expenditures without affecting the social insurance protection offered by Social Security to the needy elderly and disabled.

On the other hand, restricting program eligibility or eliminating certain types of coverage might change the nature of Social Security. For example, adding a means-testing provision could move the program away from social insurance. Moreover, elimination of even small portions of Social Security might substantially reduce certain participants' incomes, with many unable to replace these lost benefits with income from other sources.

Options for reducing Social Security benefit coverage include:

- Means-testing auxiliary benefits; and

- A five-year postponement in eliminating the earnings test for beneficiaries aged 70 and 71.

Making receipt of auxiliary (dependents') Social Security benefits conditional on income would significantly alter the character of the program. For example, benefits could be reduced to families with incomes above $10,000 from sources other than Social Security. 6/ Workers' benefits would not be affected by this proposal.

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6. Estimates of the savings from such an option are not supplied here because of the lack of necessary data and the complexity of the details of the option that would be required. Savings, however, would be large.

Since auxiliary Social Security payments are supplements to workers' benefits designed to provide additional support to extra family members, limiting dependents' benefits to families below a given income level might improve the targeting of benefits to the most needy. Such a change could also help reduce the inequities in benefits among individuals with equal contributions but unequal family size. On the other hand, a long-standing principle behind Social Security is that it provides social insurance, and many would oppose the application of a means test to dependents' benefits on philosophical grounds.

A second change would retain the earnings test for beneficiaries aged 70 and 71 through 1987 or later (see Appendix A-600-g), rather than dropping it in 1983 as is now planned. Consequently, retirees under age 72 would continue to experience benefit reductions if they earned wages in excess of an exempt amount. This option would yield savings of about $2.9 billion through 1987 and would have only a minor effect on work incentives, since few people remain in the labor force past age 70. On the other hand, some observers argue that government policies should encourage--not discourage--employment among the elderly.

Raising the Retirement Age. The final Social Security options to be discussed would raise the age of retirement either directly or indirectly. Such changes would reflect the long-run implications of improved health and life expectancy of older Americans, which may in themselves lead to later retirement. These options, which would only affect future retirees, include:

- Raising the age at which regular and early-retirement benefits are paid; and
- Increasing the number of labor-force years included in the benefit computation period.

Raising the regular retirement age for full benefits from age 65 to 68 and providing reduced benefits beginning at 65 would lower future Social Security outlays substantially. The phase-in period for such a proposal would be critical in determining both the stream of savings that would be generated and the ability of new retirees to adjust to such a major change in policy. Though a long phase-in period would avoid disruptions in retirement plans and result in substantial savings in the future, it would provide little budgetary relief in the mid-1980s. For example, an option with a relatively short nine-year phase-in would save about $500 million in 1983.

Supporters of such a change argue that future generations of retirees will remain in the labor force longer. A higher retirement age may be particularly appropriate when the post-World War II baby boom generation reaches age 65 after the turn of the century. Moreover, because the change would affect only new retirees, persons currently receiving benefits would not face reduced payments.

This approach would create hardships for those persons forced out of work before age 65 by ill health (who would not be eligible for Social Security disability benefits) or by a job-related problem such as being laid off, however. Income security coverage would be eliminated for these persons unless they become eligible for means-tested programs. Currently, about two-thirds of Social Security awards for retired workers are reduced for early retirement, so many workers could potentially be affected.

The second option in this category--a change in the AIME computation period--would affect retirees by requiring them to include more low-earnings years in benefit calculations (see Appendix A-600-a). Those who retire at 65 or later would generally have more labor-force years from which to choose for calculating benefits, although they too would be affected under this option if they left the labor force for extended periods during any part of their working lives. This option would, for example, lower the primary insurance amount (PIA) for many women who stop or suspend employment to have children. Total savings under this proposal would be about $1 billion through 1987.

Changes in Veterans' Programs

The income security programs for military veterans--pensions and disability compensation--are potential sources of appreciable outlay savings. The overriding issue for these programs is the extent to which veterans are to be extended preferential treatment. Both programs, administered by the Veterans Administration, provide services also available from other federal sources for disabled or low-income persons; but individuals who qualify for veterans' benefits receive higher amounts of cash assistance. For example, the veterans' pension program now guarantees a veteran without other resources $413 per month, compared to $265 in monthly federal benefits from SSI. 7/ Changes in veterans' programs could restrict benefits to the more needy, however.

Eliminating Veterans' Pensions. Veterans' pensions provide means-tested benefits to low-income war veterans who are at least age 65 or have total and permanent disabilities, to their dependents, and to needy survivors of war veterans. Just under 1 million veterans, 1.1 million survivors, and nearly 1 million dependent beneficiaries currently receive such pensions. These programs overlap other means-tested income security programs, particularly SSI. (The SSI program also aids the aged, blind, and otherwise disabled, although with less generous benefits than veterans' pensions.)

Gross savings from elimination of veterans' pensions would amount to nearly $3.5 billion in 1983. This amount, however, would be offset by approximately $1.1 billion in increased SSI costs, and smaller rises in food stamps, AFDC, and Medicaid, as former pension recipients become eligible for those programs. Since the income eligibility limits for veterans' pensions are higher than under SSI, current pensioners would experience a drop in benefits, and a few--mostly veterans--would have incomes too high to qualify for assistance under SSI at all.

Although other veterans' disability benefits are generally designed to compensate for some loss resulting from military service, pensions are not granted under this rationale. The requirement for disability pensions does not relate to service-connected disabilities, but rather to disabilities incurred after discharge. (Veterans aged 65 and older also qualify for veterans' pensions.) Furthermore, there is no reason to believe that the low incomes of VA pensioners are related to their military service, since veterans

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7. Many states supplement the SSI benefits, reducing the differential. In 1980, for example, the average supplement to those receiving supplements was $85 per month, but across all SSI recipients the average was only $19 per month. If these benefit guarantees were adjusted to include food stamp eligibility as well, the SSI beneficiary (with no state supplement) would gain $6 relative to the veteran, reducing the disparity in guarantees to $142. Finally, treatment of earned income for determining benefit levels varies between the two programs, so that a veteran with some earnings might not be worse off under SSI.

as a group have higher median incomes than nonveterans of the same age. This option would make benefits to this group of the population consistent with income security payments to other groups.

Defenders of veterans' pensions point out that many current beneficiaries would be ineligible for SSI or AFDC. Since these pension benefits are aimed at war veterans and their survivors, they may be entitled to uniquely high levels of protection.

This option could be modified by phasing out veterans' pensions rather than eliminating them altogether so that persons already on the rolls, particularly aged recipients, would not suffer severe hardships. For example, veterans' pensions could be eliminated for new recipients and phased out for current beneficiaries. Savings under such an option would be considerably lower.

Ending Veterans' Compensation to Persons with Limited Disability. Veterans' disability compensation provides benefits to persons with service-connected disabilities, regardless of financial need. The amount of compensation is based on the degree of impairment; payments are made to veterans with as little as 10 percent disability. Additional allowances are also paid for dependents, but only if the veteran has disabilities rated at 30 percent or more. Of the 2.3 million veterans now receiving compensation, 56 percent have total disabilities rated below 30 percent.

Veterans' compensation could be limited to those with disability ratings above 30 percent. This option would reduce federal outlays by about $1.2 billion in fiscal year 1983. Some of the nearly 1.3 million persons who would lose their benefits might be eligible for other income security programs. It is likely, however, that most of these veterans would no longer receive government support.

Veterans' disability ratings were originally designed to compensate on the basis of an average loss of earning power. With the improvements in reconstructive and rehabilitative medicine, combined with the sharp decline in the portion of the workforce performing manual labor, however, impairments of less than 30 percent may not significantly reduce an individual's ability to work. Many people with these lesser impairments, therefore, may not have reduced incomes as a result of their disabilities. This fact is already recognized to some degree by the exclusion of these individuals from entitlement to dependents' allowances.

On the other hand, if these payments are viewed as compensation for injuries incurred in service to the country, it may be irrelevant whether the recipients are able to support themselves or whether their earning ability is reduced. Under these circumstances, subjecting veterans' compensation to the same standards as other income security programs may be inappropriate.

A more modest version of the restriction on veterans' disability compensation would end payments to persons with less than 20 percent disability (see Appendix A-700-a). The arguments remain essentially the same; persons with 10 percent disability are even less likely to experience any income loss. In fact, in a small number of cases, veterans with zero disability ratings still receive compensation- albeit at very low levels. Savings from this option would total $640 million in 1983.

Changes in Other Income Security Programs

The means-tested programs are much smaller than the social insurance portions of income security. Food Stamps is the largest means-tested program, with projected 1982 outlays of $11.5 billion, or about 7 percent of Social Security retirement and disability, for example. 8/ Consequently, even large reductions in these programs would yield smaller outlay savings than many of the social insurance changes discussed above. The examples presented here focus on changing the way in which housing assistance is provided and on shifting some of the responsibility for food and nutrition programs to the states. Such changes would be less likely to affect work incentives for program beneficiaries than would direct reductions in eligibility or benefits.

Providing Rent Vouchers for Housing Assistance. Shifting all future housing assistance to rent vouchers that lower-income persons could use to reduce their housing costs in dwellings of their own choosing could reduce future subsidized housing outlays. This option could generate savings while serving the same number of households as could be aided under current programs, because

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8. Altogether, the means-tested programs discussed in this chapter should total $47.1 billion in outlays in 1982. The remaining social insurance programs are also small, with the exception of federal civil service retirement and disability, which is considered in Chapter XI.

assistance recipients would be housed in less-costly existing dwellings rather than in newly built projects, as they are under most present programs. Annual savings in moving to a voucher program could exceed $15 million for each 10,000 households assisted.

Since vouchers would be valid only for physically standard dwellings, this change would be likely to encourage maintenance of existing dwellings, although such a shift would diminish the direct federal role in promoting new residential construction. As is the case with current housing assistance programs, vouchers would be available to only a small proportion of all households qualifying on the basis of income. Local housing agencies would thus have to ration vouchers as they now ration aid under similar programs.

Requiring State Contributions to Food Stamps. Food stamps currently provide no more than $233 per month in benefits for a family of four and are limited to those with incomes below 130 percent of the poverty threshold. Benefit amounts are determined by the "thrifty food plan," designed to reflect a minimum nutritionally adequate diet. Federal outlays could be reduced further by requiring states to contribute 20 percent of the program's benefit costs. About $2.2 billion could be saved in federal outlays in 1983.

Since the states currently administer food stamps--although all benefit funding is federal--states would have a greater incentive to hold down expenditures if they were liable for at least part of the costs. Such a treatment of food stamps would be consistent with other means-tested programs (such as Medicaid or AFDC) in which states bear some of the costs of providing services. Shifting additional burdens to the states would not substantially reduce the actual total costs of the program, however, unless states were allowed to reduce benefits. In addition, poorer states tend to have greater proportions of their populations receiving food stamps, so this option would place the heaviest burden on the states least able to provide benefits--that is, those states with relatively low average per capita income.

Creating Block Grants for Child Nutrition. Funding child nutrition programs with a block grant instead of the current array of nine programs could reduce federal outlays by $5.8 billion over five years if, at the same time, the federal contribution were cut by 25 percent (see Appendix A-600-o). Although such a block grant could simplify administration and enhance state and local flexibility, it would also shift more of the burden of child nutrition programs to the state or local level. This change might result in fewer nonpoor children receiving school lunches, but that change alone would not create enough savings to compensate for the 25 percent cut.

CONCLUDING COMMENTS

From the items listed above, the largest potential source of immediate outlay reductions in the income security area is a change in the formula for automatically indexing benefits to the cost of living. If such a change were applied to Social Security, $76 billion in savings could be generated through 1987 by limiting the COLA to two-thirds of the CPI. Similarly, large savings could be generated in many other programs by delaying or reducing the automatic escalation of benefits. For example, a one-percentage-point reduction in the 1982 COLA for the Social Security, SSI, veterans' pensions, railroad retirement, and federal employee retirement and disability programs would reduce 1983 outlays by about $1.8 billion. Such changes would affect all program beneficiaries, ensuring that large outlay savings could be generated without severely restricting any one beneficiary's payments, although many SSI recipients would then have incomes even further below the poverty line.

The other major reduction strategy discussed here would eliminate benefits for groups of the recipient population least in need of federal income security. In general, these changes would affect fewer people and would generate lower outlay savings, even though each affected recipient would experience a greater loss.

The options discussed in this chapter would generate 1983-1987 savings ranging from $1 billion for changing the AIME computation period in Social Security to $76 billion for reducing the COLA to two-thirds of the increase in the CPI. These options do not represent a comprehensive list of all possible reductions in income security programs; some additional changes not mentioned here are presented as appendix items. Nonetheless, these changes illustrate some of the tradeoffs within the income security area, since nearly every option would reduce federal benefits to a particular segment of the population.

CHAPTER XI. COMPENSATION FOR THE FEDERAL CIVILIAN WORKFORCE

In fiscal year 1981, the federal government spent $72 billion to compensate the federal civilian workforce. Of that sum, roughly 90 percent went to pay some 2.1 million active employees and to disburse pensions for about 1.8 million annuitants; the remainder covered the costs of health and life insurance and workers' compensation. Outlays for pay and retirement benefits affect different portions of the federal budget; outlays for the Civil Service Retirement (CSR) system appear in the income security accounts of the budget (function 600), and payroll expenditures are distributed among the separate accounts of each federal agency. These various outlays are combined in this chapter in order to present a unified review of the compensation costs that the government, as an employer, pays, and to illustrate the relationships between federal pay and retirement and the possibilities for budgetary reductions in this area. Because the number of employees inevitably influences compensation outlays, the size and composition of the federal civilian workforce is also considered.

BUDGET HISTORY AND PROJECTIONS

Outlays for federal civilian pay and retirement have grown some 175 percent during the past decade--increasing from $24.0 billion in 1970 to $66.1 billion in 1981. If current policy is continued, these expenditures will reach $102.4 billion in 1987 (see Table XI-1). The major cause of past and future increases in compensation costs is inflation.

Historical Trends, 1970-1981

Federal Pay. During the 1970-1981 period, the federal civilian payroll increased from $21.3 billion to $48.4 billion. This growth represents an average annual increase of 7.6 percent. The number of civilian employees has decreased slightly; annual pay raises therefore account for almost all of the payroll growth. [1]

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[1] Although federal civilian employment has remained quite stable, its distribution between defense and nondefense agencies has shifted somewhat, in line with changing emphases in national priorities. Throughout the 1970s, reductions in civilian employment in Department of Defense programs have offset a 230,000 workforce increase in nondefense agencies.

TABLE XI-1. FEDERAL COMPENSATION OUTLAYS FOR CIVILIAN PAY AND RETIREMENT (In billions of dollars)

Major Programs	Actual		Estimated	Baseline Projection	
	1970	1981	1982	1983	1987
Federal Civilian Pay	21.3	48.4	50.9	55.1	70.8
Civil Service Retirement	2.7	17.7	19.8	22.0	31.6
Total	24.0	66.1	70.7	77.1	102.4

Over the years, career advances have also been reflected in higher wages and salaries, as have changes in government occupations; but to a far greater degree, the growth has been caused by annual government-wide pay adjustments that mainly reflect increases in the cost of living. Between 1970 and 1981, average federal pay raises did not keep up with changes in the cost of living, which rose at an average annual rate of 7.9 percent as measured by changes in the Consumer Price Index (CPI). After 1972, most of the annual pay adjustments were below increases in the cost of living.

The pay of federal employees is adjusted government-wide every year by procedures that compare federal salaries and wages with those paid for similar work in the private sector. 2/ The President and the Congress, however, are not bound by the comparability comparisons; and in six of the 14 cost-of-living adjustments (COLAs) since July 1969, they have adopted lower increases--all comparability pay increases for federal blue- and white-collar employees having been reduced each year since 1977. Alternative plans to pay increases have often been proposed to achieve budgetary and economic objectives and to set an example of wage restraint for the private sector.

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2. Civilian federal pay adjustments for white-collar workers occur each October on a nationwide basis and at different times of the year for blue-collar workers on a local area basis.

Contrary to a widely held misconception, the federal civilian workforce decreased slightly between 1970 and 1981--from 2.23 million to about 2.12 million. Although this change had little effect on total payroll expenditures, the responsibilities and size of the federal workforce continue to be a matter of public interest. In 1981, about 43 percent of the federal civilian workforce was employed by the Department of Defense, excluding the U.S. Army Corps of Engineers. In the same year, about one-sixth of the federal workforce provided direct nondefense services in health, transportation, and other areas. Significant numbers of federal workers were also employed in various other domestic programs that provided benefits to individuals (7 percent of total) and in natural resource management (10 percent of total). Activities slated for a reduced federal role employed relatively small numbers. About 5 percent of the workforce administered federal regulatory programs; less than 2 percent administered programs assisting state and local governments (see Table XI-2).

Federal Retirement. The CSR system, which predates and remains independent of Social Security, is intended to provide annuities that substitute for the combination of private employers' pensions and Social Security benefits. External income for the program comes from employee contributions (a withholding tax set by law at 7 percent of salary for most workers) and from payments from the U.S. Postal Service (USPS) and other off-budget agencies. The CSR fund also receives income from employing agencies, interest paid by the U.S. Treasury, and substantial federal payments appropriated directly to CSR. (Income from these sources represents internal budgetary transactions that do not affect program outlays.) The annual out-of-pocket federal cost for CSR represents program outlays that are not offset by receipts from external sources--that is, employee contributions and payments from the off-budget federal agencies. The $17.7 billion CSR outlay for 1981, for example, was partly offset by some $5.4 billion in receipts from employees and off-budget agencies, leaving a federal cost of $12.3 billion.

Between 1970 and 1981, the annual federal cost of CSR rose from $0.9 billion to $12.3 billion. During this same period, outlays for CSR increased at an average annual rate of 18.2 percent, climbing from $2.7 billion to $17.7 billion. About half (51 percent) of this growth resulted from COLAs in CSR pensions; other growth (21 percent) was caused by the net increase in the number of

TABLE XI-2. ESTIMATED DISTRIBUTION OF FEDERAL CIVILIAN WORKFORCE BY GOVERNMENTAL ACTIVITY (As of January 1, 1981)

Activity	Primary Governmental Role	Numbers of Employees	Percent of Total
National Security	Civilian employees of the U.S. Department of Defense	938,000	43.4
International Affairs	Includes the Foreign Service and other employees of the State Department and agencies administering foreign aid, information, and other programs	39,000	1.8
Internal Revenue and Customs	Covers all activities of IRS and the U.S. Customs Service	100,000	4.6
Administration of Justice and Law Enforcement	Includes the Federal Bureau of Investigation, Secret Service, administration of immigration and naturalization, and federal prisons	61,000	2.8
Regulatory Activities	More than half administer food, health, safety, and environmental regulations. About another quarter serve on boards and commissions that regulate other aspects of the economy	101,000	4.7
Social Insurance and Benefit Programs	About three-fourths administer Social Security, health-care payments, veterans benefits (other than health services), and public aid. Most of the remainder administer urban and rural housing programs and loans to small businesses	147,000	6.8

(continued)

TABLE XI-2. (Continued)

Activity	Primary Governmental Role	Numbers of Employees	Percent of Total
Natural Resource Management and Related Public Enterprises	Includes the U.S. Army Corps of Engineers, the Tennessee Valley Authority, and agencies responsible for federal land and resource management	214,000	9.9
Assistance to State and Local Governments	More than two-thirds administer federal housing and community development aid, community health, and job training programs	32,000	1.5
Direct Federal Services	Three-fifths administer veterans' health services. The remainder includes air traffic control, Indian services, the census, and other statistical or information programs	361,000	16.7
Research and Development	Nearly two-thirds handle research and development for agriculture, health, and aeronautics and space	75,000	3.5
Departmental Direction and Management and Government-Wide Support a/	Includes budget, audit, Inspector General, legal, management, and personnel functions. Government-wide support includes fiscal, property, records, and personnel administration	93,000	4.3
Total		2,161,000	100.0

SOURCE: Derived by CBO from Senate Committee on Governmental Affairs, Organization of Federal Executive Departments and Agencies.

a/ Includes activities performed under various management categories as reported by individual agencies.

CSR annuitants; a somewhat greater portion (28 percent) was brought about by increases in the size of initial benefits. [3]

The 1982 Budget Decisions

Actions on the 1982 budget denied comparability pay adjustments to federal civilian employees, reduced the frequency of retirement COLAs, shifted more workers from nondefense to defense-related jobs, and trimmed the overall size of the civilian workforce.

Pay Adjustments. Procedures for adjusting federal pay government-wide have been criticized for various technical reasons and for not taking into account the value of retirement and other fringe benefits. In lieu of enacting new standards and mechanisms for determining pay increases, the 1981 reconciliation act capped the 1982 pay adjustments at 4.8 percent for federal blue-collar and most white-collar employees. (If 1982 pay raises had not been capped, a 15.1 percent average comparability adjustment would have been implemented for white-collar employees.) This limitation follows a practice that has now capped government-wide pay raises for the last four years. [4]

Civil Service Retirement. Although the reconciliation act did not address the level of federal retirement benefits, it did decrease the frequency of COLAs from twice to once a year. The act eliminated the September adjustment, beginning in 1981, but it stipulated an annual adjustment each March that will recover 100 percent of the yearly increase in prices. This action will reduce CSR expenditures in 1982 by an estimated $0.5 billion because of the longer interval between COLAs.

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[3] Benefits for new annuitants have steadily increased because of changes in wage histories, the occupational composition of the federal workforce, as well as a revised statutory formula for computing benefits on the basis of average salary for the highest three years, rather than the highest five years.

[4] In the past, the Congress has also frozen salaries of top-level officials. The 1982 budget increased the federal pay ceiling from $50,100 to $57,500 for General Schedule employees and to $58,500 for employees under the Senior Executive Service. Had these ceilings not been in effect, salaries for some federal executives would exceed $75,000.

Active Employment. Consistent with current budgetary priorities, the 1982 budget counters past trends by slating the Defense Department for a sizable manpower increase and nondefense agencies for slightly larger decreases. Relative to 1980, the civilian workforce for nondefense agencies is projected to decline by 3.4 percent through September 30, 1982 while the civilian workforce for the Defense Department increases by 1.5 percent. Overall, it is assumed that the workforce will therefore decline slightly, but the Defense Department's share will rise by 1.2 percentage points over its 1980 share. The near-term savings from cutbacks in civilian agency employment are likely to be partly offset by layoff expenses, including severance pay, refunds of employees' accumulated contributions to the federal retirement plan, and by other layoff benefits. In calendar year 1981, for example, nondefense agencies cut back some 68,000 jobs by not filling vacated positions and by laying off some 11,800 workers. The cost of payments to the laid-off workers will, according to a conservative estimate, shrink the full-year employment reduction savings from $1.5 billion to $1.3 billion (estimates annualized on a 12-month basis). [5]

Baseline Projections, 1983-1987

During the 1983-1987 period, if no changes in current policy are effected, combined outlays for federal civilian pay and retirement are projected to grow from $77.1 billion to about $102.4 billion. This represents an average annual increase in payroll expenditures of 6.5 percent and a 7.5 percent average increase in annual benefit costs for CSR.

The five-year projections for federal civilian payroll costs reflect no reductions in the size of the workforce beyond those already achieved in 1982. The estimates also reflect an extension of the 1982 budget resolution assumptions, which call for continued restraint in federal pay adjustments and no comparability catch-up. The 1983-1987 pay raise projections, however, slightly exceed estimated increases in the cost of living--suggesting a 3.1 percent total real growth in income during the next five years.

Between 1982 and 1987, CSR outlays are projected to grow from $19.8 billion to $31.6 billion--an increase of 60 percent--with about three-fifths of this growth resulting from automatic COLAs. The remaining outlay rise will come about because of increases in the number of CSR annuitants and, to a somewhat lesser degree, because of larger average annuities earned by new civil service retirees. (The projections also assume COLAs will continue on a once-a-year basis.)

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[5] In addition to CBO's estimates, other estimates of layoff costs have been prepared by some individual Executive Branch agencies, including the Department of Education.

BUDGET STRATEGIES

Despite recent budgetary reductions enacted by the Congress, federal compensation still offers potential for further savings. In particular, annual civilian pay adjustments and the CSR program remain obvious targets. (Federal compensation costs might also be reduced by individual program cutbacks identified in the other chapters and the Appendix items in this report. 6/) In debating what course of action to take concerning federal pay and retirement, the Congress will want to consider both the budgetary effects and the workforce implications of measures that could accelerate federal retirement.

With regard to federal pay, the CBO baseline--consistent with the 1982 budget resolution--assumes that annual pay increases will continue to be restrained in 1983 and subsequent years. The Congress may decide, of course, that federal pay adjustments must be further reduced in response to economic and budgetary concerns. Also, additional savings could be conceivably justified under a "total compensation" approach (discussed in this chapter), which would compare federal and nonfederal pay and benefits. In essence, the government's cost of providing superior retirement benefits would be offset by reducing the size of future pay increases. Such pay reform, as well as a continuation of limits on pay increases, would encourage federal workers to retire as soon as they are eligible for pension benefits. Thus, the government could lose the skills, productivity, and experience of senior federal employees who elect early retirement. The repercussions from this behavior would increase in the long run as the number of younger workers entering the job market declines.

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6. The reduction examples in this report having impact on payroll expenditures include elimination of various farm payments and support programs, small business loan guarantees, transportation grants and subsidies, and limiting the number of veterans eligible for certain benefits and the number of veterans' health facilities.

As an alternative to further limits on pay increases, the Congress could consider changing the Civil Service Retirement program. Such consideration would be hampered, however, by the absence of any statutory or generally agreed-on criteria for evaluating the reasonableness of current CSR benefits, contribution rates, and associated federal costs. Under current policy, CSR can be construed as a model program that sets an example for other employers. This perspective could be replaced by one that sought to bring federal costs of CSR into alignment with what would prevail if the government adopted retirement practices more like those of the private sector. If the Congress took this approach two possible courses of action for CSR could be considered: reducing CSR benefits (see Appendixes A-600-d, A-600-j and A-600-1), or raising the payroll withholding rates that partly fund the system (see Appendix B-600-h).

Reducing CSR Benefits

Compared with the two-part retirement income of private-sector retirees--an employer-provided pension plan, plus Social Security--benefits under CSR are relatively large. The two areas in which differences have the most significant cost effects are age of eligibility and COLAs. Enrollees in CSR may draw unreduced pensions as young as age 55, and their benefits are kept abreast of inflation through annual adjustments that fully reflect changes in the CPI. In the past, COLAs were effected more than once a year, and each adjustment equaled the change in the CPI plus a one-percentage-point add-on. The add-on was enacted in 1969 to compensate for the lag between benefit adjustments and increases in the cost of living, but it had the effect of instituting permanent overcompensation. As of October 1976, the Congress eliminated the COLA add-on; but the legislation did not apply retroactively to adjustments already received.

The cost of COLAs to the federal government has become progressively higher every year because of increases in the numbers of annuitants, the upward trend of wages, and the intrinsic compounding of new COLAs on top of previous ones. In 1970, for example, each one-percentage-point adjustment caused annual outlays to increase by $24 million; in 1981, however, each such one-percent adjustment added some $190 million to annual outlays. The cost of COLAs is neither recognized in nor funded by the employee contribution to CSR (7.0 percent of pay for most workers). This omission has been a major factor in federal cost increases for CSR.

Benefit changes other than COLA and early-retirement limitations that would bring CSR benefits into closer alignment with private sector practices include basing initial benefits on employees' average salaries for five rather than three years of highest earnings; and requiring retirees with living spouses to accept an actuarial reduction in their initial annuity or waive survivor protection for their spouses.

COLA Limitations. Because CSR COLAs have exceeded the pay raises awarded to federal employees still in active service, many CSR retirees already on the rolls now receive greater pensions than they would if they retired today at the same grade level and with the same length of service. For example, the pension of an employee who retired in 1970 is at least 30 percent greater than would be the pension of a worker electing to retire in 1983 with the same work history. The difference narrows for more recent retirees--some 6 percent for employees who retired in 1980. This "extra" income results from two aspects of CSR indexation: COLAs from 1970 through 1976 included the one percentage-point add-on to changes in the CPI; and second, COLAs during the last decade have usually exceeded annual pay adjustments for white-collar workers.

A relatively easy correction for the extra CSR income could be achieved by temporarily reducing future COLAs for persons who have already retired. For example, if a 50 percent cap were applied to future COLAs for employees who retired since 1970--the primary group benefiting from overindexation--CSR outlays would fall by $0.2 billion in 1983 and $1.8 billion in 1987, yielding a five-year total of some $5.0 billion. Because the amount of excess benefits (income over what would be received if retirement occurred in 1983) relates to date of retirement, the temporary COLA reduction would terminate at different times, depending on year of retirement; none would last beyond 1992. [7]

Using COLA reductions to reduce gradually the "excess" CSR benefits would avoid both administrative problems and the costs of recalculating benefits for some 1.4 million retirees. On the other hand, temporary COLA limits or detailed recalculation would most certainly be opposed as a largely unprecedented action that would amount to a retroactive, downward benefit adjustment.

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7. A similar temporary COLA reduction is proposed for retired military pay (see Chapter III).

Patterning CSR after common private-sector treatment of retirement increases could bring down the level of federal outlays. Aligning future CSR adjustments to estimated COLAs received in the private sector--for current as well as new annuitants--would reduce 1983 benefit outlays by $0.3 billion and accumulate outlay savings of some $8.2 billion through 1987. This departure would entail limiting the size of annual COLAs for federal retirees.

Throughout much of the private sector, pensions are increased on an ad hoc basis to reflect rises in the cost of living; only a handful of private firms offer any guaranteed COLA. Private sector retirees aged 62 and over, however, are eligible for Social Security, which, under current law, is automatically indexed to recover 100 percent of changes in the CPI. Nonetheless, revised CSR pensions modeled on the dual private-sector annuity package would provide a far less ample cushion against inflation than CSR offers today. The data available suggest that prevailing private-sector retirement income recovers an estimated 33 percent of CPI for annuitants under age 62 and roughly 70 percent when Social Security benefits become available. If such adjustments applied to CSR, a typical federal retiree and survivor--receiving projected 1983 annual CSR benefits of $14,400 and $6,100--would suffer income reductions of some $240 and $100, respectively.

Early Retirement. Under current law, CSR benefits are available, without reduction, to persons aged 55 after at least 30 years of federal service or to those aged 60 after 20 years of service. Reducing earned benefits for federal workers who retire before age 65 would be more consistent with the present provisions of the Social Security program.

A 2 percent per year reduction could be phased in, eventually reaching 10 percent at age 60 and 20 percent at age 55. The maximum early-retirement reduction would still be less severe than that required by the Social Security program. Social Security's provisions, which grant no retirement benefits to persons younger than age 62, impose primary annuity reductions of 6 2/3 percent per year for persons retiring between ages 62 and 65. Because Social Security represents a large part of most retirees' incomes, few workers can afford earlier retirement even if private pension benefits are available. The Social Security limitations are especially significant because a number of private pension plans reduce the earned annuity only if retirement occurs before age 62 or in some instances, age 55.

Reducing CSR's early-retirement benefits over a 20-year phase-in period would decrease outlays by only about $5 million in the first year of implementation--1983--but it would have a greater long-term impact. Cumulative savings between 1983 and 1987 would reach $0.3 billion. Without the phase-in period, however, CSR costs would rise sharply, since employees would accelerate their retirement plans to avoid benefit reductions.

Calculation of Initial Benefits. Under current law, the size of initial CSR benefits is determined in part by the employees' three years of highest earnings--commonly referred to as "high-three." 8/ A high-five basis is much more common in the private sector--at least for white-collar employees--and was the basis used prior to 1970 in computing CSR annuities. Reinstatement of a five-year average for calculating initial benefits for new retirees could save an estimated $0.05 billion in 1983 and generate savings of $1.4 billion through 1987.

Survivor Coverage. In accordance with CSR provisions, some 70 percent of the 100,000 federal employees retiring each year elect reduced benefits in order to allow for coverage for their surviving wives or husbands. To receive this coverage, the initial employee annuity is reduced by 2.5 percent for the first $3,600 and by 10 percent for CSR pension income over $3,600. This reduction is the same for all annuitants, regardless of differences in the ages of annuitants and spouses. The current reduction formula differs markedly from private pension practices.

In order to conform with the private sector, the CSR reduction for survivor coverage could be based on actuarial factors that would vary the reduction according to the ages of the retiree and the spouse. This would remove a certain inequity in the current system that benefits some spouses and married annuitants and disadvantages single retirees. Because actuarial reductions would be greater for most new retirees than under current law, this change would save $0.8 billion between 1983 and 1987. (Implementing legislation for changes in initial benefits and reductions for survivor coverage would need to be effective a short time before

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8. Under current law, the size of the initial CSR pension (without reduction for survivor coverage) is determined by multiplying average salary for the highest three years of earnings times a percentage rate that usually includes 16.25 percent for the first ten years of service and 2.0 percent for each additional year of service.

enactment in order to limit accelerated retirements and their associated costs. On the other hand, some critics would maintain that these changes should be phased in over a number of years, because many employees have undoubtedly planned their retirement already.)

Increasing CSR Contributions

As an alternative to reducing CSR benefits, the Congress could choose to increase CSR contributions to help defray the costs of the program's superior provisions. In particular, an increase in the employee contribution rate from 7 percent to 9 percent of pay would fund about half the margin of indexed federal pensions over private ones. 9/ If the employee contribution rate were increased to 9 percent over three years, five-year savings in federal costs for CSR could reach $5.8 billion. The increase in the matching agency contribution would also generate further budgetary savings because of the added income from the USPS and other off-budget agencies. The combined increase in funding from external CSR income (contributions from employees and off-budget agencies) could accumulate to $6.9 billion through 1987.

Increasing CSR contribution rates would cover some of the high cost of COLA increases. Furthermore, the increase in employing agency contributions also offers a step toward better recognition of retirement costs in operating programs. In particular, the increased payments from the USPS and other public enterprises could reduce what now amount to unrecognized subsidies for their operations. Proponents of raising contribution rates point out that the CSR fund would be depleted this year were it not for federal payments that have been centrally appropriated from the general fund of the U.S. Treasury.

Increased CSR withholdings would reduce the take-home pay of the nearly 2.7 million employees, including postal workers,

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9. The estimated 2 percent increase is drawn from long-term (50 year) economic and cost assumptions for CSR prepared by the system's Board of Actuaries and from other data concerning cost-of-living adjustments awarded in private sector. The estimates are highly sensitive to the long-term economic assumptions. Changes in private-sector COLA practices could also affect the two percent estimate; but current data suggest that the amount of indexation in private-sector plans has not changed much in recent years.

currently participating in the system. About 85 percent of these workers receive annual salaries ranging between $10,000 and $30,000. This proposal would also exert upward pressure on postage rates. (Over the next five years, postage rates might rise by as much as 0.8 percent to recoup higher agency costs for CSR withholdings.) Opponents argue that active employees cannot afford an increase in contribution rates in light of inflation and past limits on annual federal pay raises. In addition, they observe that most private-sector plans, albeit less generous, require no employee contributions.

In view of recent limitations on federal pay, increasing the mandatory retirement contributions could also create employee recruitment and retention problems in some sectors of the federal workforce. For example, in an agency such as the Defense Department, where employment is slated to expand, recruitment problems could ensue, because qualified employees or job applicants might prefer take-home pay at the expense of lower deferred benefits such as retirement. On the other hand, recruitment problems for most civilian agencies would not likely occur at this time, in view of high unemployment in the national economy and current or forthcoming cutbacks in federal jobs.

Total Compensation

A major federal reform debated in recent years would require the value of fringe benefits to be considered when determining compensation comparability between federal and nonfederal jobs. Such a departure from existing procedures, which determine federal pay and benefit levels independently, is termed the "total compensation" approach. Current law provides that federal pay rates should be comparable with private enterprise rates for equivalent work. But in recent years, the government has essentially departed from this principle, as budgetary and economic considerations have kept federal pay raises below those of the private sector. A total compensation approach would basically trade the advantage from superior federal retirement benefits against the size of future federal pay adjustments. 10/

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10. Total compensation legislation proposed by the Administration for the 1982 budget also included a federal comparability standard that would eventually equate federal compensation to 94 percent of nonfederal pay and benefits. The Administration justified the 94 percent standard as a way to recognize certain intangible advantages of federal employment such as promotion potential and job security.

The Congressional Budget Office has observed that total compensation comparisons are highly uncertain and subject to a wide degree of discretion in the mechanics and design of a comparative framework. Thus, different methodology (mechanics and design) could lead to different pay adjustments--either below or above the 7.0 percent projected by CBO under current policy. A reduced 1983 pay adjustment, however it might be constructed, could be justified either as a necessary measure to accommodate budgetary constraints or as a refinement of a total compensation proposal. If the size of annual federal pay adjustments were one percentage point lower for each of the next five years, annual federal payroll expenditures would fall by $0.4 billion in 1983 and by $2.5 billion in 1987. During this period, payroll reductions would accumulate to some $7.1 billion.

CONCLUDING COMMENTS

Limiting federal compensation costs for civilian pay and retirement benefits could yield significant budgetary savings. Although CBO projections assume federal pay adjustments will remain below private-sector increases, the President may recommend a still lower pay figure for 1983. A one-percentage-point reduction enacted in the 1983 pay raise--from 7 to 6 percent--would accumulate a five-year savings of $1.7 billion. But continuing to hold down federal active-service pay adjustments, in lieu of reducing retirement benefits, could prompt federal managers and experienced employees with valuable skills to accelerate their retirement plans.

The Congress could always take a different course of action and modify federal retirement provisions. The CSR program remains the single most costly federal fringe benefit, and the one that differs most markedly from practices in the private sector--allowing employees to retire earlier and affording them greater protection against inflation. If the federal costs of the CSR system are viewed as excessive in light of private-sector practices, there are only two ways to decrease them: either reduce benefit levels, or raise contributions paid by employees and off-budget agencies.

Post-retirement COLAs have the most significant cost effect on CSR outlays. The Congress could also consider other CSR benefit modifications, including reductions for early retirement, changing the formula for calculating initial benefits, or redistributing the cost of survivor coverage. All of these changes would help align the federal retirement system with private-sector practices and reduce annual expenditures. But such changes would counter long-standing policy that favors protection of income received by retired persons. 11/

Raising retirement contribution rates would reduce the government's cost for CSR benefits at the expense of federal employees' take-home pay. But in view of continued limitations on federal pay adjustments, increased payroll withholdings could create recruitment and retention problems. The short-run impact would be moderated, however, by relatively high general unemployment rates and reductions in force in many federal agencies.

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11. Federal policy favoring protection of retirement income is reflected in various programs and tax provisions. Examples include Social Security and its indexation, Medicare, the Employee Retirement Income Security Act, extra federal income tax exemption at age 65; and certain tax credits.

CHAPTER XII. TAX REVENUES

Federal government revenues come principally from individual income taxes (currently about 47 percent of total revenues), social insurance taxes (about 33 percent), and corporate income taxes (about 8 percent). The remaining 12 percent of federal revenues comes from excise taxes, estate and gift taxes, user charges, and various other sources.

The Economic Recovery Tax Act of 1981 (ERTA) will reduce tax revenues by large amounts in future years--by an estimated $95 billion in fiscal year 1983, rising to $294 billion in 1987. These tax reductions pose a sharp dilemma for the Congress and the President. Unless federal spending is cut further, or revenues are increased, there is little prospect of a balanced budget in the foreseeable future.

This chapter discusses a variety of ways in which revenues could be increased. More detail on a number of options for cutting tax expenditures--special tax provisions intended to encourage certain activities and to assist certain groups--is included in Appendix B.

BUDGET HISTORY AND PROJECTIONS

Total federal revenues have remained relatively constant as a percentage of gross national product (GNP) since 1970, although an upward trend was discernible in the last several years. This trend was reversed by the Economic Recovery Tax Act of 1981, which will ultimately reduce revenues as a percentage of GNP to levels comparable to the lowest levels of the 1950s and 1960s.

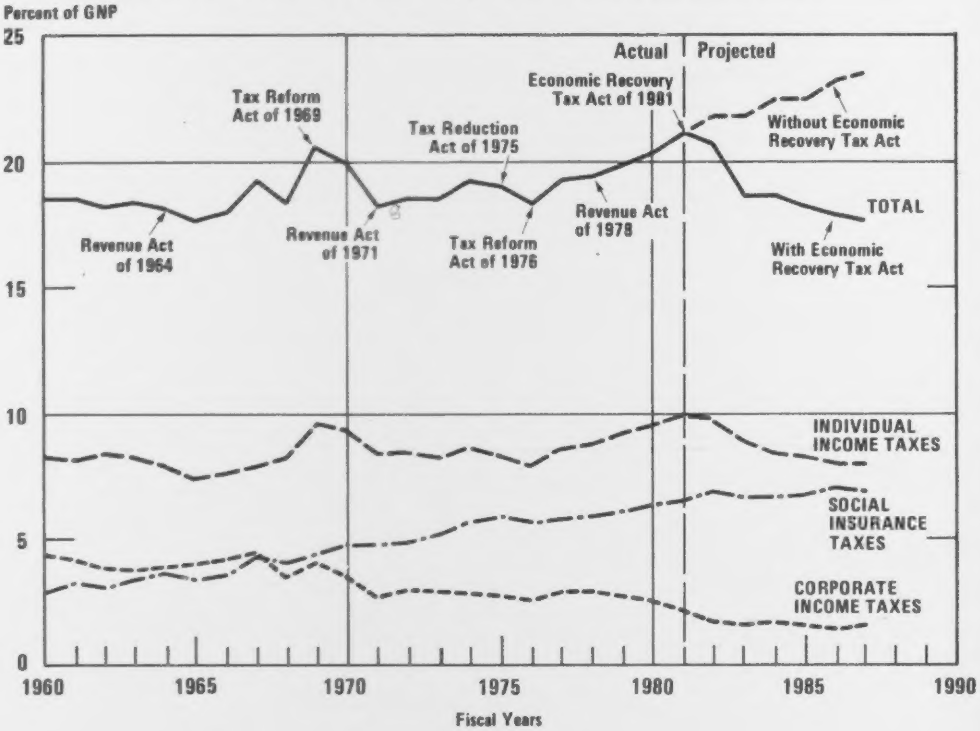
The composition of total revenues has changed substantially in the past decade, however, with social insurance taxes making up an increasingly larger share and the corporate income tax share declining steadily. These trends will continue during the 1983-1987 period.

Historical Trends, 1970-1981

Total federal revenues rose from $193.7 billion or 20.0 percent of GNP in fiscal year 1970 to $602.6 billion or 21.1 percent of GNP in fiscal year 1981. Revenues as a percentage of GNP dipped as low as 18.2 percent during the 1970s, however, and did not reach a level above 20 percent again until 1980 (see Figure XII-1). Inflation and economic growth tend to increase revenues as a percent of GNP, but this tendency was largely offset by the tax cuts enacted in 1969, 1971, 1975, 1976, 1977, and 1978.

Figure XII-1.

Federal Revenues as a Percentage of GNP, 1960 to 1987



While the individual income tax share of total revenues has remained quite constant over this period, the social insurance tax share has grown from 23 percent of the total in 1970 to 31 percent in 1981, and the corporate income tax share has declined from 17 percent in 1970 to 10 percent in 1981 (see Table XII-1). The growth in the social insurance share has resulted from the need to finance large increases in Social Security benefits enacted during the 1970s, especially the enactment in 1972 of an immediate 20 percent benefit increase, followed by automatic annual cost-of-living increases. The largest Social Security tax increase during the period was that of 1977, which provided for steep increases in the Social Security tax base and a schedule of rate increases extending into the next century. The decline in the corporate income tax share has resulted mainly from increases in the investment tax credit, more liberal depreciation allowances, and other special tax provisions aimed at stimulating particular kinds of investment. The top corporate rate was also reduced from 48 percent to 46 percent during the period.

The Economic Recovery Tax Act of 1981

CBO estimates that the Economic Recovery Tax Act will reduce revenues below what they otherwise would have been by $95 billion in fiscal year 1983, and $294 billion in fiscal year 1987. The largest share of this reduction ($65 billion in 1983 and $147 billion in 1987) is due to a 23 percent cut in individual income tax rates that will be phased in over three years. The next largest share ($19 billion in 1983 and $60 billion in 1987) results from the new capital cost recovery system for business depreciation.

The reduction in income taxes in the 1981 act will lower individual income tax revenues to 8.0 percent of GNP by 1987, a level equal to the lowest year in the 1970s, but above the 7.4 percent level reached in the lowest year of the 1960s. As discussed later in the chapter, for taxpayers as a whole this reduction in income taxes will more than offset the tax increases from inflation if these increases are measured from late 1981, but not if the starting point is January 1979, the effective date of the last tax cut. The tax cuts enacted during the 1970s approximately offset the effects of inflation for taxpayers as a whole.

The corporate income tax reductions in the 1981 Act are much larger than those of earlier years, and will reduce corporate income tax revenues as a percentage of GNP to below 2 percent for the first time since 1941. This reduction in corporate income taxes continues a trend that has extended over the last three decades. Corporate income tax revenues averaged 5 percent of GNP during the 1950s, 4 percent during the 1960s, and less than 3 percent during the 1970s.

TABLE XII-1. BUDGET REVENUES BY SOURCE, SELECTED FISCAL YEARS, 1960 TO 1987

Source	1960	1970	1981	1982	1983	1987
			(Billions of dollars)			
Individual Income Taxes	40.7	90.4	285.6	299.9	302.7	396.3
Corporate Income Taxes	21.5	32.8	61.1	50.4	50.7	73.0
Social Insurance Taxes and Contributions	14.7	45.3	186.4	208.9	227.4	339.0
Excise Taxes	11.7	15.7	40.8	41.4	39.8	39.8 a/
Other	3.9	9.5	28.7	30.7	31.0	33.8
Total	92.5	193.7	602.6	631.3	651.6	881.9
			(As a percent of total revenues)			
Individual Income Taxes	44.0	46.7	47.4	47.5	46.5	44.9
Corporate Income Taxes	23.2	16.9	10.1	8.0	7.8	8.3
Social Insurance Taxes and Contributions	15.9	23.4	30.9	33.1	34.9	38.4
Excise Taxes	12.6	8.1	6.8	6.6	6.1	4.5 a/
Other	4.2	4.9	4.7	4.9	4.8	3.8
Total	100.0	100.0	100.0	100.0	100.0	100.0
			(As a percent of GNP)			
Individual Income Taxes	8.2	9.3	10.0	9.8	8.8	8.0
Corporate Income Taxes	4.3	3.4	2.1	1.6	1.5	1.5
Social Insurance Taxes and Contributions	2.9	4.7	6.5	6.8	6.6	6.8
Excise Taxes	2.3	1.6	1.4	1.4	1.2	0.8 a/
Other	0.8	1.0	1.0	1.0	0.9	0.7
Total	18.5	20.0	21.1	20.6	19.0	17.7

NOTE: Details may not add to totals because of rounding.

a. CBO's baseline revenue projections for 1987 include the extension of highway trust fund taxes. This adds $4.5 billion to excise taxes in 1987.

Baseline Projections, 1983-1987

The revenue outlook for the period from 1983 to 1987 is dominated by the effects of the Economic Recovery Tax Act. Total revenues as a percentage of GNP are projected to decline from 21.1 percent in 1981 to 19.0 percent in 1983 and 17.7 percent in 1987, the lowest level since 1965 (see Table XII-1 and Figure XII-1). All major sources of revenue are projected to level off or decline as a percentage of GNP from 1983 to 1987 except for social insurance taxes. The increases in Social Security taxes scheduled during this period--an increase in the rate from 6.7 percent in 1983 to 7.05 percent in 1985 and 7.15 percent in 1986, and automatic increases in the wage base each year--will push social insurance taxes as a percentage of GNP from 6.6 percent in 1983 to 6.8 percent in 1987. As a share of total revenues, social insurance taxes will climb from 35 percent in 1983 to over 38 percent in 1987.

Corporate income tax revenues are projected to drop to 8.3 percent of total revenues and 1.5 percent of GNP by 1987, the lowest percentage of GNP since 1940. The major reason for this drop is the Accelerated Cost Recovery System (ACRS) of business depreciation. The depreciation deductions provided by ACRS, in combination with the investment tax credit, are so large that they will frequently more than offset a firm's current earnings. Such firms will thus pay no corporate income taxes, and will in addition have deductions and credits that they will be unable to use to offset current income. To give such firms the same tax incentive to make new investments as firms that have enough income to use all their deductions and credits, ACRS includes a provision that substantially liberalizes the rules for leasing business assets. Under these new leasing rules, firms with extra deductions and credits can, in effect, sell them to firms that have enough income to use them. The payments the selling firms receive approximate the tax savings they would receive if they were able to make full use of the deductions and credits themselves. By reducing the amount of unused deductions and credits, leasing increases the federal revenue loss from ACRS by about 20 percent over what it would otherwise have been. These anticipated effects of leasing have been included in the revenue projections for 1983-1987 in this chapter.

BUDGET STRATEGIES

There is a potential conflict between the goal of reducing the federal deficit and that of reducing the role of the federal government in allocating resources. The goal of reducing the federal deficit can be achieved either by increasing revenues or by reducing outlays. Reducing outlays also reduces the federal role in the allocation of resources, but raising revenues may allow the federal role to be maintained or increased. Currently, total revenues are projected to fall to just 17.7 percent of GNP by 1987, a lower level than outlays have reached in any year since 1956. To reach a balanced budget at that level of revenues would require an extraordinary reduction in outlays from their post-World War II high of 23.1 percent of GNP in 1981. Combining some increase in revenues with further cuts in outlays would thus still permit a substantial reduction in the current role of the federal government.

Some ways of increasing revenues may reduce the role of the federal government in the economy. Increases in user charges, for example, could reduce the federal role in resource allocation by requiring the beneficiaries of federal facilities and services to pay their full cost rather than having part of the cost subsidized by the taxpayers at large. Similarly, increasing revenues by reducing tax expenditures would reduce federal intervention in the allocation of resources.

There are three general ways of reducing the deficit through revenue measures:

- Some of the multiyear individual and business tax cuts enacted in 1981 could be reduced, postponed, or repealed.
- Existing tax law could be tightened by reducing tax expenditures, eliminating obsolete incentives, and reducing tax abuse and avoidance.
- New or increased taxes could be enacted, such as a windfall profit or excise tax on natural gas; tariffs or fees on imported oil; higher excise taxes on alcohol, tobacco, and gasoline, and other items; expanded user fees for federally provided services; or a national value-added or sales tax.

Going beyond these kinds of incremental changes, a more fundamental restructuring of the income tax system could also be considered, such as a broader-based income tax with fewer deductions, exclusions, and exemptions, thus permitting substantially lower rates, or replacement of the income tax altogether with a broad-based consumption or expenditure tax. These approaches would not necessarily increase revenues, however. Attempts to cushion the inevitably difficult transition to a wholly new tax system by softening its impact on groups of taxpayers to prevent possible hardship could easily result in reduced total revenues.

Scaling Back the 1981 Tax Cut

Since the major individual income tax cuts in the Economic Recovery Tax Act are scheduled to be phased in over time, substantial amounts of revenue could be raised by postponing, reducing, or eliminating some of them. Postponing the scheduled July 1983 10 percent rate cut by one year, for example, would increase revenues by $27 billion in fiscal 1984 (see Table XII-2). The scheduled rate cuts could also be reduced. As shown in Table XII-2, reducing the 1983 rate cut to 5 percent would increase revenues by $18 billion in fiscal year 1984 and $20 billion in fiscal year 1985. The act also provides for annual indexing of the individual income tax for inflation, starting in 1985. Eliminating this provision would increase revenues by $12 billion in fiscal year 1985 and $51 billion in 1987, using CBO inflation assumptions. Other options for scaling back the 1981 individual income tax cuts are also shown in Table XII-2.

In considering any of these possible reductions in the individual income tax cuts, it is important to keep in mind that some or all of the cuts simply offset the tax increases that would otherwise occur as inflation, pushing taxpayers into higher tax brackets. As shown in Table XII-3, if these tax increases from "bracket creep" are measured from October 1, 1981, the date of the first installment of the rate cuts enacted in 1981, 40 to 65 percent of the rate cuts are offset by inflation. If the base for measuring bracket creep is taken back to January 1, 1979, the effective date of the last income tax reduction prior to the 1981 act, the 1981 rate cuts are more than offset in the aggregate by the accumulated tax increases from bracket creep. For many individual taxpayers, especially those with lower incomes, the scheduled income tax reductions will not be enough to offset bracket creep even when measured from October 1981; reducing or postponing the scheduled reductions would leave even more taxpayers with higher real tax burdens than they had in 1981.

TABLE XII-2. REVENUE INCREASES FROM SCALING BACK THE INDIVIDUAL INCOME TAX CUTS IN THE ECONOMIC RECOVERY TAX ACT OF 1981 (By fiscal year, in billions of dollars)

Modification	1983	1984	1985	1986	1987
Delay 1983 Rate Cut by					
Three months	8	a/	---	---	---
Six months	9	8	---	---	---
One year	9	27	---	---	---
Reduce 1983 Rate Cut to 5 Percent	4	18	20	22	24
Reduce 1983 Rate Cut to 5 Percent on July 1, 1983 and 5 Percent on July 1, 1984	4	14	1	1	1
Eliminate 1983 Rate Cut	9	37	40	44	47
Eliminate Indexing	---	---	12	30	51
Eliminate 1983 Rate Cut and Indexing	9	37	54	76	102

NOTE: The act provides for an across-the-board reduction in individual income tax rates of 10 percent on July 1, 1982, and another 10 percent on July 1, 1983. Starting in 1985, rate brackets, the zero bracket amount (standard deduction), and personal exemptions will be indexed annually for inflation.

a. Less than $0.5 billion.

As discussed earlier, the business tax reductions in ERTA will reduce corporate income tax revenues to their lowest share of GNP in more than 40 years. These tax reductions could be scaled back by, for example, keeping the maximum allowable depreciation under the capital cost recovery system at the current 150 percent declining balance rate rather than allowing it to increase to a 175 percent rate in 1985 and 200 percent in 1986 and thereafter. This would increase revenues by $14 billion in fiscal year 1986 and $19

TABLE XII-3. REVENUE EFFECTS OF 1981 INCOME TAX RATE CUTS COMPARED WITH INFLATION-INDUCED INCOME TAX INCREASES (By fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986	1987
ERTA Individual Income Tax Rate Cuts a/	25	65	102	128	161	198
Income Tax Increases from Bracket Creep b/						
Starting October 1, 1981	11	26	48	71	98	128
Starting January 1, 1979	70	93	121	151	184	222

a. Includes $12 billion for indexing in 1985, $30 billion in 1986, and $51 billion in 1987.

b. Estimated by calculating the difference between the income tax revenues that would be collected in the absence of the Economic Recovery Tax Act, and those that would be collected if the income tax were indexed for inflation beginning on October 1, 1981, or January 1, 1979. Assumes increases in the Consumer Price Index of 11.3 percent in calendar year 1979, 13.5 percent in 1980, 10.3 in 1981, 7.5 in 1982, 6.9 in 1983, 6.9 in 1984, 6.4 in 1985, 6.0 in 1986, and 5.7 in 1987.

billion in 1987. Another option would be to eliminate the increase in the investment tax credit for short-lived assets that was enacted in 1981. Reducing the credit from 6 percent to 3-1/3 percent for three-year assets, and from 10 percent to 6-2/3 percent for five-year assets, would increase revenues by $2 billion in 1983 and $10 billion in 1987.

The leasing provisions of ERTA account for about $4 billion of the estimated $19 billion capital cost recovery revenue loss in 1983, and about $9 billion of the estimated $60 billion loss in

1987. Some revenue could thus be saved by tightening up or eliminating these leasing provisions. To do so, however, would place firms with low current profits and/or large investment plans at a competitive disadvantage in financing their capital investments. Scaling back the underlying depreciation and investment tax credit provisions would have a more even effect on overall investment than a cutback in leasing, since cutting back leasing would exclude only selected firms from depreciation tax savings.

A number of smaller provisions of ERTA have also been suggested as possible candidates for repeal or scaling back, including the exemptions from the windfall profit tax ($1.6 billion revenue loss in 1983 and $3.2 billion in 1987) and the reductions in the estate and gift tax ($2.3 billion in 1983 and $7.4 billion in 1987).

Reducing Tax Expenditures, Obsolete Incentives, and Tax Avoidance

Increasing tax revenues by cutting tax expenditures or removing obsolete incentives would at the same time reduce federal intervention in the economy. Tax expenditures are subsidies in the form of special tax provisions designed to stimulate particular kinds of economic activity or to relieve hardship. The Domestic International Sales Corporation (DISC) tax provisions, for example, are intended to stimulate exports, while the extra $1,000 personal exemption for persons over age 65 is intended to reduce the tax burden on a part of the population that tends to have lower incomes. Like federal spending programs, these special tax provisions are a way of allocating resources to some groups or sectors of the economy at the expense of others.

This chapter includes a variety of options for reducing tax expenditures. They are listed in Table XII-4, along with the estimated revenue gains that would result in fiscal years 1983 and 1987. Each option is discussed in more detail in Appendix B.

Some or all of the revenues raised from cutting back these special provisions could be used to finance across-the-board cuts in individual and corporate tax rates or other broad forms of tax reduction, such as general increases in business depreciation allowances. Since large multiyear individual and business tax cuts have already been enacted, selective changes in the tax structure would help fill the revenue gap left by these general tax cuts. Repealing the income tax deduction for state and local sales taxes, for example, would raise about $0.8 billion in new revenue in

TABLE XII-4. REVENUE GAINS FROM POSSIBLE REDUCTIONS IN TAX EXPENDITURES, FISCAL YEARS 1983 AND 1987 (In billions of dollars)

Tax Expenditure Reduction	1983	1987
International Affairs		
Phase out Domestic International Sales Corporations	0.1	0.9
Energy		
Modify tax treatment of foreign oil and gas income	0.2	0.7
Repeal percentage depletion allowance for oil and gas	0.8	2.4
Repeal expensing of intangible oil and gas drilling costs	3.5	9.6
Repeal residential energy tax credits	0.1	a/
Eliminate excise tax exemption for alcohol fuels	0.1	0.1
Natural Resources and Environment		
Eliminate capital gains treatment of timber	0.3	0.8
Eliminate tax exemption for pollution control bonds	a/	1.0
Commerce and Housing Credit		
Limit home mortgage interest deduction to $5,000	1.8	8.8
Tax 10 percent of the capital gain on home sales	a/	0.4
Tax accrued interest on life insurance reserves	1.5	4.1
Terminate deductibility of consumer interest payments	1.2	9.6
Eliminate tax exemption for small issue industrial revenue bonds	0.1	2.5
Limit business meal and entertainment deductions to 80 percent of amount spent b/	0.3	0.7
Community and Regional Development		
Eliminate tax credits for rehabilitating older buildings	0.8	1.7

(Continued)

TABLE XII-4. (Continued)

Tax Expenditure Reduction	1983	1987
Education, Training, Employment, and Social Services		
Tax scholarship and fellowship income	0.1	0.4
Repeal extra parental personal exemption for students	0.3	0.8
Tax fringe benefits b/	0.5	1.6
Health		
Tax some employer-paid health insurance		
Income tax	2.0	6.0
Payroll tax	0.6	2.1
Tighten the medical expense deduction	0.4	3.8
Eliminate tax exemption for private hospital bonds	0.1	1.1
Income Security		
Eliminate extra tax exemption for the elderly and blind	0.8	2.8
Tax half of retirement benefits for Social Security recipients with incomes above $20,000/$25,000	1.6	3.1
Tax railroad retirement benefits	0.2	0.2
Tax workers' compensation benefits	1.5	6.7
Tax all unemployment insurance benefits	1.9	1.8
Repeal the casualty loss deduction	0.1	1.2
Veterans' Benefits and Services		
Tax veterans' disability compensation	0.8	2.5
General Purpose Fiscal Assistance		
Eliminate deductibility of state and local sales taxes	0.8	7.8
Limit tax credit for possessions corporations	0.2	0.6

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a. Less than $50 billion.

b. The deduction of business meal and entertainment expenses and the non-taxation of fringe benefits are not considered tax expenditures.

fiscal year 1983 and $7.8 billion in fiscal year 1987. Increases in the tax base of this kind would not significantly reduce the incentive effects of the reductions in marginal tax rates enacted in 1981, since the amounts added to taxpayers' incomes in most cases would not push them into higher tax brackets. While enactment of a large number of base-broadening measures could push many taxpayers into higher brackets, this could be offset by further reductions in marginal tax rates.

Many tax incentives for particular kinds of business investment may have become less necessary or obsolete after the enactment of major increases in business depreciation allowances in 1981. The DISC export incentives, tax-exempt small issue industrial revenue bonds, the percentage depletion allowance for oil and gas, and the expensing of intangible oil and gas drilling expenses are examples of the kinds of provisions that could be reexamined in light of these new general business tax cuts.

Tax collections can be increased without a legislated increase in tax liabilities by improving the enforcement of existing tax laws. Providing the Internal Revenue Service with additional resources for audits and collections could bring in at least $4 in new revenues for each $1 spent. Instituting a system of withholding for independent contractors could increase tax collections by about $600 million a year, while instituting withholding on interest and dividends could increase tax collections by $3 to $5 billion a year. None of these provisions would involve new taxes; they would simply improve the collection of taxes that are already owed.

Introducing New or Increased Taxes

Revenues could also be increased by new or increased taxes on energy, user charges, and selective or general taxes on consumption.

Windfall Profits or Excise Taxes on Natural Gas. Price controls on most domestic natural gas are due to be lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA). The deregulation of natural gas prices at the wellhead, whenever it occurs, will probably result in a substantial increase in gas prices and producer revenues and profits. In a decontrolled market, natural gas prices would most likely tend toward the heat-equivalent (Btu) price of the major fuels with which gas competes, most notably oil. The NGPA, however, has held prices below this level. For example, industrial and utility boiler fuel sold for approximately $5.50 per million Btus in the fall of 1981, while natural gas was delivered to these users for $2.98. For residential users, home heating oil sold for $9.00 per million Btus, while gas was delivered for $4.60 in the same period. These differences suggest that substantial new gas industry profits would follow upon wellhead decontrol. These profits could be the focus of a windfall profits tax on natural gas at the wellhead.

The revenues raised by such a tax, and the duration of the tax, would depend upon the adopted definition of "windfall" income. One option for such a tax would be to allow the deregulation of all wellhead gas prices on January 1, 1983. This option would create a "windfall tax base," that is, new revenues to natural gas producers in excess of those they would have received under NGPA, of up to $30 billion in 1983 and $40 billion in 1984. Applying to this base a windfall profits tax similar to that on oil could produce as much as $12 billion in revenues in each of these years. This figure must be regarded as a maximum, however, since prices might not increase as rapidly as this calculation assumes. In addition, higher profits for natural gas producers might lead to reduced profits and incomes in other sectors of the economy, especially if tight monetary policy holds down overall nominal GNP. These lower incomes would result in offsetting reductions in corporate and individual income taxes in those other sectors. Taking all these factors into account, the net revenue gain from decontrol and a windfall profit tax on natural gas could be as low as $1 billion in 1983 and $6 billion in 1984.

If the tax was not limited to the period of accelerated decontrol, it could raise large amounts of revenue in the period after 1984. For example, an excise tax of $0.60 per thousand cubic feet--unrelated to any windfall--would raise approximately $11 billion per year after 1984.

A windfall profits tax on natural gas would differ from the existing crude oil windfall profits tax in several respects. The most important difference is that, unlike the oil tax, a windfall profits tax on all gas would raise the price of gas to consumers. In the oil case, producers were forced to absorb the tax because of the competitive pressure exerted by large imported supplies that entered the United States at the market price. No such source of competitive gas exists. Domestic gas price increases are checked only by the possibility of long-term switching to other fuels, most probably to oil. Thus, a tax on all gas would be borne by producers and consumers, with a possible inflationary impact over and above that of natural gas decontrol alone.

In the absence of a windfall profits tax on natural gas, decontrol would increase producer revenues substantially, and with them corporate and personal income tax revenues from the natural gas industry. These tax increases could, however, be partly or wholly offset by effects elsewhere in the economy. Corporate profits and personal income outside the gas industry might decrease as the composition of national output changed in response to higher gas prices. Inflation could increase during the adjustment to higher gas prices, possibly also dampening growth. This could reduce federal tax revenues in general, and perhaps also increase those automatic transfer payments that are associated with reduced GNP growth or tied to measures of inflation. Thus, it is not clear that decontrol of natural gas alone--in the absence of a windfall profits or excise tax--would increase total federal tax revenues or reduce the deficit in the short run. In the long run, decontrol would increase economic efficiency, thus increasing both real GNP and federal revenues.

Tariff on Imported Oil. A tariff or fee on imported oil would reduce U.S. dependence on foreign oil sources by inducing further energy conservation and the substitution of other fuels for oil. The adoption of such a fee would raise the price of domestic oil by the amount of the fee, since domestic oil prices are effectively set by the price of imported oil. Thus, an import fee would raise revenues both from the fee and the additional windfall profit taxes paid by producers of domestic oil.

A fee of $5.00 per barrel would produce approximately $17.5 billion in annual revenues from these two sources, assuming imports of 5.5 million barrels per day and domestic production of 8.5 million barrels per day. Of this total, $10 billion would come from fee collections, and $7.5 billion from higher windfall profits tax collections from the domestic industry. Such a fee would result in an increase of approximately 12 cents per gallon in the price of refined products, including gasoline and heating oil, although some of the increase would be passed back to refiners, producers, and manufacturers who use oil as an input into production. To the extent that their profits were reduced, the revenues raised by the fee would be offset by reduced income tax collections. Beyond this, if tight monetary policy prevented overall nominal GNP from rising, the price increases resulting from the fee would be absorbed in the form of lower real incomes throughout the economy, resulting in further offsetting reductions in income tax collections. The net increase in revenues could thus be significantly less than the gross amount collected from the fee and higher windfall profit taxes. It is estimated that a fee of $5.00 per barrel could reduce U.S. oil consumption by approximately 300,000 barrels per day within one year.

An increase in oil prices, whether resulting from a fee or from market forces, requires some adjustment in the economy. Such an adjustment would not be without cost. Industries and regions dependent on oil would be most heavily affected. In the automobile industry, for example, higher gasoline prices could increase somewhat the demand for smaller, more fuel-efficient cars, and could lead to further erosion of the market share of U.S. automobile manufacturers.

The magnitude of the adjustment costs might depend on the manner in which the oil import fee was instituted. Raising the fee gradually to some target level over time, for example, would enable oil users to make anticipatory adjustments through conservation or fuel-switching, thereby reducing their transition costs. The benefits of an oil import fee would be increased substantially if it was instituted multilaterally by the major importing nations, since it would reduce worldwide oil consumption by a greater amount than would a fee adopted by the United States alone. The larger demand reduction would exert greater pressure on producers to lower oil prices, and, in turn, the final product prices paid by consumers, thus providing many of the same benefits as a unilateral U.S. fee while reducing the inflationary consequences of this option.

Excise Taxes. Doubling current excise taxes on cigarettes, alcohol, telephones, and gasoline could increase revenues by $12 to $14 billion a year (see Table XII-5). Some of these taxes have not been raised in many years, so increases might be justified simply on those grounds. In addition, the reduction in consumption that might result from higher excise taxes could in some cases serve broader social purposes--reduced dependence on foreign oil in the case of gasoline taxes, for example, and the concern for public health in the case of alcohol and tobacco taxes. The measure would, however, increase federal influence over the allocation of resources by selectively making some consumer goods more costly than they would otherwise be. These excise taxes also fall more heavily, as a proportion of income, on those with lower incomes than on those with higher incomes.

TABLE XII-5. GROSS REVENUE INCREASES FROM DOUBLING EXISTING EXCISE TAXES (By fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987
Liquor ($21/gallon)	3.3	3.5	3.5	3.7	3.7
Beer ($18/barrel) and Wine (34 cents/gallon)	1.3	1.3	1.4	1.6	1.7
Cigarettes (16 cents/pack)	1.8	1.8	1.9	2.1	2.3
Telephones (2 percent)	0.8	0.8	1.8	2.0	2.2
Gasoline and Diesel Fuel (8 cents/gallon)	3.2	4.6	4.5	4.4	4.4
Total	10.4	12.0	13.1	13.8	14.3

NOTE: All taxes shown above are double the present rates and assumed to become effective on January 1, 1983. The one percent telephone excise tax is scheduled to expire as of January 1, 1985, under present law. The net increase in budget receipts would be smaller than the amounts shown above because of offsetting reductions in individual and corporate income taxes.

--Liquor. The liquor tax of $10.50 per gallon has not been changed since 1951. Doubling it to $21.00 would raise about $3.5 billion a year and put the tax at about 45 percent of the product price, slightly more than the 43 percent that the $10.50 tax represented in 1951. Estimates of the resulting decline in liquor consumption range from zero to almost 60 percent.

--Beer and Wine. The excise taxes on beer and wine were also last raised in 1951. Doubling them would raise about $1.3 billion a year in new revenue. Since the taxes comprise a very small share of the total price, the increases would have an insignificant effect on consumption.

--Cigarettes. The 8 cents-per-pack tax on cigarettes has also not been raised since 1951. Doubling it would raise about $1.8 billion a year in new revenue. A 16 cents-per-pack tax would represent 24 percent of the per-pack cost, less than in 1951 when 8 cents represented 37 percent of the cost per pack. Most studies indicate that cigarette consumption does not decline very much in response to increases in the price, except among young people. One recent study suggests that an 8 cents-per-pack increase (12 percent of the total price) could result in up to a 30 percent decrease in the number of teenage smokers.

--Telephones. With a few brief exceptions, the excise tax on telephone service remained at 10 percent from 1932 until 1973, when it began to be reduced by 1 percent a year, with expiration scheduled for January 1, 1983. As a result of 1981 legislation, it will remain at 1 percent through 1984, after which it is scheduled to expire. Increasing the tax to 2 percent and continuing it beyond 1985 at that level would raise about $0.8 billion in new revenue in 1983 and $2.2 billion in 1987.

--Gasoline. The excise tax on gasoline was increased from 3 to 4 cents per gallon in 1959, and it has remained at that level since then. Doubling the current 4-cent-per-gallon tax would raise would raise about $4.4 billion a year, although o[illegible] reductions in corporate and individual taxes would hold the net increase in revenues to about $3.3 billion a year. The higher price would result in a small decrease in fuel use--estimated at about 40,000 barrels a day--which would reduce state fuel tax receipts by about $60 million a year. In general, with the price of gasoline at about $1.35 a gallon, a 4-cent increase would have only a modest economic impact.

While such a tax increase could be added to general revenues to help reduce the deficit, gasoline taxes have traditionally been viewed as user charges and assigned to the Highway Trust Fund. The current $4.4 billion in receipts provides about two-thirds of the taxes paid into this fund. Higher fuel prices and greatly improved fuel economy have reduced the revenues from the tax in recent years to the point that outlays from the Highway Trust Fund exceeded revenues by over $1 billion in 1981. At the same time, preliminary results of a new federal highway cost allocation study indicate that automobile users currently pay a higher share of highway taxes than is warranted by the costs they impose on the highway system, while the heaviest types of trucks pay less than the costs they impose. An increase in gasoline taxes might have to take into account some of these funding and allocation issues.

--Luxuries. Excise taxes on "luxuries"--furs, jewelry, luggage, and toilet preparations--were enacted during World War II and repealed in 1965. A 10 percent excise tax on these items would raise about $2.5 billion a year, with about $1 billion each coming from jewelry and toilet goods, and the rest from furs and luggage. A 10 percent excise tax on luxury cars could raise about $1 billion a year, while a 10 percent tax on expensive boats could raise around $100 million a year.

User Fees. Revenues could also be raised by imposing fees on some federal government services that are now provided free of charge or at less than their cost. In effect, the government is transferring income and resources to the beneficiaries of these services. User fees could require the cost of services to be paid by those who use them. The Administration proposed a number of new and increased user fees last year to cover the costs of airports and airways, ports, waterways, Coast Guard services, grain inspection, and the like. The Congress has not given final approval to any of these proposals. It should be noted that the proposals often did not increase fees by the full amounts necessary to cover the costs of the services provided. Chapters V and VII of this report and Appendix B contain a number of options that would require users to pay some or all of the costs of the services provided. Some of these are listed in Table XII-6, along with the revenues they would raise in 1983 and 1987.

Value-Added Tax or Sales Tax. A national value-added or sales tax that applied to a comprehensive range of goods and services would distort the allocation of consumption resources less than the kinds of selective excise taxes discussed earlier. Such a tax could be viewed as simply an incremental change to the present tax system if it was established at a relatively modest level and did not substitute for any of the current major sources of tax revenue. A large-scale value-added tax, however, would verge on the kind of fundamental change discussed in the next section.

Large additional revenues could be raised by a national value-added or sales tax. For every percentage point, such a tax would raise from $10 to $15 billion in revenue, depending on how comprehensive it was. A national sales tax--if modeled after existing state and local sales taxes--would be levied at the retail level. A value-added tax (VAT), by contrast, would be imposed at

TABLE XII-6. POTENTIAL REVENUE INCREASES FROM SELECTED USER FEES, FISCAL YEARS 1983 AND 1987 (In billions of dollars)

User Fee	1983	1987
Increase Aviation User Fees a/	0.7	1.2
Finance the Strategic Petroleum Reserve with a Petroleum Tax b/	2.9	2.9
Increase Waterway User Charges b/	0.7	0.9
Levy User Charges for Deep-Draft Navigation Expenses b/	0.5	0.7
Levy User Charges for Certain Coast Guard Activities b/	0.7	1.1

a. January 1, 1983 effective date.

b. October 1, 1982 effective date.

each stage of the production, distribution, and sales process on the amount of "value added" at each stage, and passed on in the form of a higher price to the next purchaser. If, for example, raw materials were purchased for $10, a value-added tax of 10 percent would require the purchaser to pay $1 in tax to the seller, who would remit it to the government. If the purchaser then processed these materials, adding enough to their value to sell them to a distributor for $20, he would collect a $2 value-added tax from the distributor, take a credit for the $1 tax he had paid earlier, and pay the $1 remaining to the government. If the distributor sold the goods for $30, he would collect a $3 value-added tax from the purchaser, take a $2 credit for the VAT he had paid earlier, and send the remaining $1 to the government. The final consumer would pay a tax of 10 percent of the full price, but since he would be unable to pass it on to anyone the result would be the same for him as an ordinary sales tax of 10 percent.

While never used in this country, value-added taxes are common in Europe, where they have taken the place of unpopular "turnover" sales taxes that allowed no credit for taxes paid at earlier stages in the chain of distribution. The main argument for a national value-added or sales tax in the United States is that it would tax consumption rather than saving. If this new tax replaced part of the individual or corporate income tax, both of which impose a significant tax on saving, the overall burden of the tax system on saving would be reduced.

A major argument against such a tax is that it would shift more of the total tax burden to lower-income people, who spend a larger share of their incomes for consumption than do those with higher incomes. This regressive effect could be alleviated through a system of credits and rebates, but only at the cost of additional complexity. Certain types of goods, such as food, medicine, and other necessities, are often exempted from value-added or sales taxes, also adding complexity and inefficiency to the system.

A value-added or sales tax would increase the price of all goods and services to which it applied, and thus would lead to a one-time increase in the overall price level. If monetary policy permitted nominal GNP to rise by the full amount of the tax, there would be offsets elsewhere in the budget. Outlays for programs tied directly or indirectly to the rate of inflation would rise, as would income tax revenues. If monetary policy held overall nominal GNP down, however, the value-added tax would show up in the form of lower profits and incomes, which would reduce income tax collections.

Imposing a value-added or sales tax would involve substantial administrative and compliance costs, especially if it had to be collected at every stage of the production, distribution, and sales process. This suggests that a value-added tax might not be worth imposing unless it was set at a relatively high level of 5 or 10 percent. Any national value-added or sales tax, and especially a high one, would intrude on an important traditional source of state and local revenues. It would increase the financial pressure on state and local governments, which already face cutbacks in federal aid and--in many areas--new statutory or constitutional limits on property and other taxes.

More Fundamental Changes

A more fundamental restructuring of the tax system could also be considered. Two major possibilities are a broad-based income tax with fewer deductions, exclusions, and exemptions, thus permitting lower tax rates, and replacement of the present income tax with a broad-based consumption or expenditure tax.

Broad-Based Income Tax with Lower Rates. Broadening the income tax base by including forms of income that are currently exempted in part or completely from tax, or taxed at lower rates, would make it possible to raise more revenue than the current tax system with lower overall tax rates. An income tax system with a top marginal rate of less than 30 percent could raise the same amount as the present system if such major forms of income as capital gains and employer contributions to employee benefit plans were fully included in income, and if deductions such as nonbusiness interest expenses and state and local taxes were reduced or eliminated. Somewhat higher tax rates, or an even more inclusive tax base, would raise more revenue than the current system. This would be, in effect, a more comprehensive version of the option discussed earlier, which involved elimination of selected tax expenditures in exchange for some reduction in tax rates. A truly comprehensive income tax would eliminate all tax expenditures, with a corresponding reduction in overall tax rates.

Consumption or Expenditure Tax. While there has been much academic discussion of substituting an expenditure or consumption tax for the present income tax, no country currently has such a tax. The major advantage of a consumption tax, in the view of its proponents, is that it would not tax income that is saved.

A consumption tax could be collected in much the same way as the current individual income tax. Each taxpayer would count up all forms of income received, and then subtract all amounts saved, including money put into savings accounts, purchases of stocks and bonds, investment in businesses, and retirements of prior debt. The tax would be levied on the remainder, representing consumption. This is quite similar to the way deposits in Individual Retirement Accounts are now treated--contributions are deductible when deposited but are taxed upon withdrawal.

While all forms of saving would be deductible without limit, the definition of taxable receipts would be much broader than it now is. All receipts of spendable cash would be subject to tax, including the entire proceeds of sales of capital assets (not just the capital gain) and all amounts borrowed. If these amounts were saved or reinvested, however, they would not be taxed. An investor could borrow a sum of money (a taxable receipt) and save it (a deduction for saving) with no tax consequences.

A comprehensive consumption tax would need somewhat higher rates than a comprehensive income tax to raise the same amount of revenue, since the exclusion of savings reduces the potential tax base by about 5 percent. It could have lower rates than the present income tax, however, since the income tax base has been substantially eroded by exclusions, deductions, and exemptions. There is no guarantee that a consumption tax base would not also be subject to erosion.

Would Fundamental Changes Increase Revenues? While fundamental changes of the kinds just outlined could in theory raise large amounts of additional revenue, even with lower tax rates, the difficulties involved should not be underestimated. Any fundamental change would inevitably increase taxes for those who are taxed relatively lightly by the current system. One way of cushioning the transition to a new system would be to exempt or "hold harmless" for a period of time those who would experience relatively large tax increases. This could reduce or eliminate any potential revenue gain from the new system for a considerable period of time.

CONCLUDING COMMENTS

The Economic Recovery Tax Act of 1981, which is already in place, will reduce total revenues to less than 18 percent of GNP over the next five years, while outlays will remain at around 23 percent of GNP unless further cuts in spending are made. This five percent gap--the largest since World War II--could be narrowed with three kinds of tax changes: postponement or elimination of some portions of the 1981 tax cut, elimination of some of the special preferences in existing tax law, or enactment of new or increased taxes.

CHAPTER XIII. THE CREDIT BUDGET--LOANS AND LOAN GUARANTEES

The federal government conducts a variety of loan and loan guarantee programs in which it plays the role of a bank or other financial institution: it chooses who can borrow funds and under what terms. These programs are intended to reallocate credit resources toward selected uses, often with the inducement of below-market interest rates. The reallocation of credit by the government can be costly both to taxpayers and the efficiency of U.S. credit markets. Furthermore, federal credit has been expanding faster than direct federal spending, partly because its costs are not easily identified.

This chapter is concerned with the effects of federal lending on the economy, even if no unified budget costs are incurred. Although reduced federal credit activities would, in some instances, result in lower outlays, the long-term government costs associated with federal credit programs are small because most loans are eventually repaid. The full costs, however, are felt throughout the economy in those cases where reallocated capital causes a reduction in growth and productivity.

Federal credit activities use a large and increasing share of total available credit, often without adding to its supply. If the supply of credit for private uses is diminished, some private borrowers are "crowded out" and interest rates are bid up. As the government frequently selects borrowers according to criteria other than maximum return on investment, the substitution of federally for privately chosen borrowers may also lead to a reduction in the efficient use of capital.

Federal credit activities are understated in the budget totals. In 1982 about 30 percent of total direct loans are expected to be financed by off-budget federal entities, such as the Federal Financing Bank. Off-budget loans constitute an unrecognized government deficit, adding dollar-for-dollar to federal borrowing needs. Since off-budget loans were first used in 1974, they have added almost $94 billion to outstanding federal debt. They are expected to add an additional $16 billion in 1982. The amount of new on-budget direct loans is also understated in the budget, which records only the net of new loans less repayments. In addition, government-guaranteed loans made by private lenders are also excluded from the budget, unless the borrowers default.

This chapter suggests three mutually compatible means to reduce the growth in federal credit. It employs the credit budget framework, developed in 1980 explicitly to deal with the off-budget treatment of federal credit programs. The credit budget presents the total amount of credit channeled through the government: new direct loan obligations and new loan guarantee commitments. Since 1980, aggregate figures for new direct loans and loan guarantees have been proposed in the President's budget and enacted in the concurrent budget resolutions by the Congress. Limitations have been included in appropriations bills, setting maximum figures for many lending programs. This chapter addresses the impact of credit on the economy by focusing on lending levels rather than the traditional budgetary impact.

BUDGET HISTORY AND PROJECTIONS

During the last decade, and particularly during its last half, federal loan and loan guarantee programs have expanded rapidly. Throughout the decade the housing sector has been the most important recipient of federal credit assistance, accounting for about a third of all direct loans and two-thirds of loan guarantees (see Appendix A-370-a). During the past few years new varieties of federal credit programs have been developed--including loans for energy development and aid to large failing businesses--at the same time programs in traditional areas have continued to expand and diversify. There are now major credit programs in 12 of the 16 programmatic budget functions.

Historical Trends, 1970-1980

During the 1970s, net direct loans extended per year (new loans minus repayments) rose from $3 billion in 1970 to $24 billion in 1980. During the same period, annual net loan guarantees increased from $8 billion to $32 billion. This brought the total of oustanding loans and loan guarantees to $462 billion in 1980. Since 1976 federal credit has grown 27 percent per year, more than doubling every three years. By contrast, direct spending rose at a rate of about 12 percent annually during these years. By 1980, one of every eight dollars in federal aid (excluding tax expenditures) was extended in the form of a direct loan or loan guarantee.

Federal credit has also increased faster than total domestic credit. In 1976, 9 percent of all funds advanced in credit markets were direct or guaranteed federal loans. By 1980 that proportion had risen to 16 percent. At the end of 1980, one-quarter of all outstanding debt in national markets was federally backed securities--Treasury or federal agency securities or guaranteed loans.

The reasons for the surge in federal credit during the 1970s are not fully understood, but several contributing factors deserve notice. First, increasing market interest rates in recent years have driven a large wedge between the interest rates offered by fixed-rate federal loan programs and the rates available to borrowers through private institutions. This has increased demand for the low-interest federal loans, which are now heavily subsidized, and has probably contributed to higher program levels. This is one factor in the increase in the Guaranteed Student Loan program, which provides postsecondary students with 7 and 9 percent loans (see Appendix-500-d).

A second factor contributing to the overall growth in federal credit activity during the late 1970s was the surge in Federal Housing Administration (FHA) mortgage insurance--now the largest single federal credit program. After changing little during the first part of the decade, the dollar volume of outstanding FHA-insured single-family mortgages increased from $50 billion in 1976 to nearly $78 billion in 1980. This increase occurred during a period of rapidly rising housing prices and steeply increasing mortgage-interest rates.

The third and fourth factors relate to changes in the budgetary treatment of federal credit. In 1974 the Federal Financing Bank began operations, allowing some budget agencies to transform their on-budget direct loans into off-budget loans and others to transform guaranteed loans into off-budget direct loans. Access to federal funds at near Treasury interest rates, with no impact on the unified budget, may have contributed to higher lending levels for those programs.

Also in 1974, the Congressional Budget Act was passed. This act established a process allowing the Congress to control federal spending, but loan guarantees were specifically excluded from its coverage. The change in control over direct spending relative to loan guarantees may have encouraged an increasing use of the guarantee mechanism.

The 1982 Budget Decisions

The reconciliation process did not directly affect the credit budget, as the budget resolutions contained no instructions to Congressional committees for reducing gross lending levels of credit programs. The 1981 reconciliation act did, however, modify several credit programs (including loans by the Farmers Home Administration (FmHA), Small Business Administration (SBA), and Guaranteed Student Loan program) in ways that lowered program subsidies. Interest rates for FmHA disaster loans were increased to market rates for comparable loans, a change expected to decrease the demand for these loans. Several SBA lending programs were consolidated and direct loan levels were lowered (see Appendix A-370-c). The reconciliation act also imposed a needs test for higher-income borrowers under the reduced-interest Guaranteed Student Loan program and imposed a 5 percent origination fee for all new loans.

In September 1981, the Administration announced a series of proposed reductions in loan guarantees for 1982 to be effected largely through administrative action. The proposals included a $16 billion decrease in secondary guarantees of the Government National Mortgage Association (GNMA) mortgage-backed securities program and $4.3 billion in reductions under other credit programs, the largest being the Export-Import Bank, the SBA, and the Rural Electrification Administration (REA). (The REA reduction requires legislation first.) To the extent that these changes are adopted administratively, program levels established as ceilings in appropriation acts are being modified without opportunity for Congressional review, since the Impoundment Control Act of 1974 does not apply to federally guaranteed loan programs.

CBO estimates that the credit budget total for 1982 will reach $147 billion. This total will include $87 billion in new loan guarantee commitments and $60 billion in new direct loan obligations. In addition, $68 billion in secondary guarantees, largely by GNMA, are expected, although these are not included in the credit budget total.

BUDGET STRATEGIES

Federal credit programs change the way the private sector allocates credit to meet two general objectives: correct market failures or provide subsidies to preferred borrowers. Many federal credit programs are intended to achieve both objectives to some extent.

Federal intervention in credit markets is efficient from an economic standpoint if it corrects an inability of credit markets to perform one of their primary tasks, such as reducing risk through spreading it among a multitude of investors or accurately judging the riskiness of a potential loan. It is frequently argued, for example, that FHA mortgage insurance corrected a market misjudgment of the riskiness of long-term, low-downpayment mortgages.

If a credit program is operating in an area in which there is no market failure, the federal assistance is best understood as a reallocation of credit, often at subsidized interest rates, to specific activities or borrowers. This reallocation may sacrifice some economic efficiency. It draws credit away from private uses that must meet strict risk/return criteria and delivers it to federally selected borrowers who may not meet these criteria. In effect, it substitutes a political judgment about prospective borrowers for the market's judgment.

If the government wishes to provide a subsidy, it might be preferable in some instances to provide it directly through a grant rather than through a low-interest loan. This is because the total cost of a credit subsidy may be difficult to determine and is not always apparent in federal budget documents. Also, part of the cost may not appear until later years. The cost of a direct grant of comparable value, by contrast, would be clear, and would be acknowledged in government accounts as soon as it was made.

Reducing federal credit programs would entail two primary strategies: elimination of credit programs in areas in which there is no market failure and reductions in credit subsidies. Programs whose aims are being met by the private sector could be eliminated on the grounds that market failures no longer exist. Credit subsidies could be ended entirely either by raising interest rates to market levels or by halting the programs (and substituting direct grants, if needed). In cases in which market imperfections warrant subsidized credit, a third approach could be taken: reform of eligibility criteria to ensure that the subsidies are used cost-effectively.

Terminating Federal Programs That Duplicate Private Sector Lending

If the government is providing services that overlap or override private sector activities, the government might wish to discontinue these services. The question to be addressed in these cases is whether the private provision of the service would differ significantly enough from the federal program to warrant the program's continuation, at least in part.

For instance, FHA mortgage insurance was originally designed to correct flaws in private credit markets by supplying funds in a form not supplied by private lenders. Today, however, the housing market has accepted the long-term, low-downpayment mortgage that FHA pioneered. The program, therefore, may no longer be needed to serve that purpose. Private mortgage insurers already sell similar insurance, and might be able to take over a large part of FHA's business. The private sector, however, would not provide the same benefits to low- to moderate-income homebuyers who now receive a cross-subsidy from higher-income FHA borrowers. Although curtailing FHA mortgage insurance would not reduce unified budget outlays, it could reduce government intervention in credit markets by as much as $30 billion in 1983.

Government National Mortgage Association (GNMA) guarantees of securities backed by FHA insured or Veterans Administration (VA) guaranteed mortgages constitute a similar example. The securities were developed to bring new investors into mortgage markets, thereby increasing the availability of funds. Mortgage-backed securities are now available for conventional mortgages, as well as FHA or VA mortgages. If these new instruments gain the acceptance that GNMA securities now enjoy, the mortgage market might be able to function efficiently without GNMA. Under current law, GNMA will be permitted to make up to $68 billion in guarantee commitments in 1982.

The Rural Electrification Administration was also designed to meet an earlier credit market gap that may no longer exist--the inability of rural utilities to raise capital to extend electric service to remote areas. Now that almost all homes and businesses have access to electricity, the capital needs of rural utilities may be more similar to those of other utilities. Since REA lending is heavily subsidized, however, these utilities would face higher interest costs. Eliminating REA lending programs would reduce federal intervention in credit markets by $5.5 billion in guaranteed lending in 1983. (Appendix A-270-f presents a proposal to reduce, not eliminate, REA lending.)

The U.S. Synthetic Fuels Corporation is an example of a fairly new program designed to override market conditions. Under current policy, synfuel loan guarantees will be extended to oil companies that are hardly in need of subsidized credit. Moreover, the increased price of oil resulting from decontrol has improved the competitiveness of synfuels, providing incentives for energy companies to make synfuels investments without a subsidy. Eliminating synfuel guarantees would also result in a reduction of federal intervention in credit markets (see Appendix A-270-e).

Eliminating or Reducing Interest Subsidies

The present value of explicit interest subsidies in new federal credit extensions for 1982 is currently estimated at nearly $15 billion, assuming that borrowers could have obtained funds unaided at 15 percent. This does not include the implicit subsidies resulting from government support to riskier borrowers and projects than those financed by private markets. If interest rates and other loan terms were set at market levels, federal loan volume would decline. This would result in savings from increased interest receipts per dollar loaned as well as lower outlays from reductions in loan levels.

Below market rates and guarantee fees provided through the Export-Import Bank are an example of this kind of federal credit. These subsidies benefit owners and workers of exporting companies and foreign purchasers at the expense of U.S taxpayers, importers, and consumers. Reduced subsidies would result in outlay savings of $342 million over the next five years (see Appendix A-150-c).

Higher interest rates could also be used to reduce subsidies in the farm ownership and operating loan programs of the Farmers Home Administration (see Appendix A-350-a). Availability of subsidies may have encouraged some marginal farms to remain in operation. Though this provides support to the farm owners, it does little to improve their productivity or to increase the food supply. Raising interest rates on these programs would result in outlay savings of $387 million over the next five years.

Because of recent high interest rates, programs whose interest rates were fixed by statute some time ago or whose formulas allowed their rates to grow more slowly than market rates now offer substantial subsidies where none or little was originally intended. The Congress might, therefore, wish to revise these interest rates and other loan requirements to bring them up to date, and to improve their flexibility so that subsidy levels do not automatically fluctuate with market interest rates. For example, the maximum interest rate under the Guaranteed Student Loan (GSL) program was set at 7 percent in 1965, when the government's own borrowing costs were less than 5 percent. Over the years, as market interest rates rose to 17 percent and higher, the GSL borrower's interest obligation remained at 7 percent, with the government paying the difference. Recognizing that the subsidy had grown, the Congress reduced it at the end of 1980, by raising the interest rate to 9 percent for all new borrowers. Even so, the subsidy remains high. Currently it is 7 percent on top of the 9 percent paid by the borrower. The costs of this program could be further reduced by again raising the students' borrowing charges to take into account continuing high market interest rates.

Revising Eligibility Criteria and Loan Terms

The two strategies outlined above provide approaches to federal credit that, if consistently applied, would eliminate or thoroughly restructure most existing credit programs. In practice, the Congress might wish to move more slowly in curtailing federal credit activity and, instead, initiate a set of interim steps to alter the operation of current programs.

If the Congress wished to continue to provide subsidized credit for certain activities, it might choose to target assistance more narrowly. Stricter focusing of eligibility requirements and tightening of unnecessarily lax loan terms could make existing programs more cost-effective by directing subsidies to those in need of assistance without aiding potential borrowers who have an unduly high risk of default.

Tighter eligibility rules would lead to a smaller number of loans with little diminution in program effectiveness. For example, the government could limit the Aircraft Purchase Loan Guarantee Program to airlines serving small communities. By directing loan guarantees to commuter carriers that generally serve communities of less than 5,000 persons and through stipulations on appropriate aircraft size, the current $650 million ceiling on loan guarantees could be reduced.

The Food for Peace (P.L. 480) credit sales could be limited to countries in which the United States has a strong foreign policy interest or which are experiencing food shortages (see Appendix A-150-b). The present program frequently includes lending to countries that do not need the commodities urgently but only purchase them because of the large subsidy. Similarly, loan terms for foreign military sales and economic support loans (see Appendix A-150-a) to middle-income countries could be revised. The loan terms for economic and military aid to U.S. allies are now designed to meet the needs of the poorest nations. But setting lower standards to help these countries also permits such lending to wealthier countries that could borrow with higher interest and shorter maturities.

PROMOTING SOUND BUDGETING PRACTICES

Much of the mushrooming of federal credit programs has occurred because the size and the cost of the programs have been omitted or obscured in budget totals. Correcting the budgetary treatment of federal credit activities may be one of the best vehicles for inducing a reduction in federal lending in the long run, although it would produce this result only indirectly. The problem described in this section arises from the use of the Federal Financing Bank (FFB) as a source of inexpensive, off-budget financing for on-budget agency programs.

Sales of Certificates of Beneficial Ownership. Several direct lending agencies, notably the Farmers Home Administration and the Rural Electrification Administration, sell securities backed by their loan portfolios--certificates of beneficial ownership (CBOs)--to the FFB. The sale of these certificates is treated in agency budgets as a reduction in their volume of outstanding loans, that is, as a receipt. Through the sale of CBOs, the agencies can transfer the dollar volume of their loans (though not responsibility for servicing them or any risk) to the FFB and thus, to off-budget status. This allows the agencies to make a larger number of loans without showing any increase in their own budgets. Budget experts have long argued that the CBOs would be more appropriately treated as a means of financing the agencies' lending, and that the loan outlays should remain under the budget accounts of the agencies that originally make the loans.

FFB Extensions of Agency-Guaranteed Loans. A number of agencies providing loan guarantees use the FFB as their banker. Borrowers with agency guarantees can get federal direct loans from the FFB at rates only slightly higher than Treasury rates. In this manner, loan guarantees by budget agencies are converted to off-budget direct loans. The FFB substitutes for a private financial institution, but assumes no servicing functions; all responsibility for the loans remains with the guaranteeing agency. A budget accounting more accurately reflecting the source of funds and accountability for the loan would treat these as on-budget direct loans by the guaranteeing agencies.

These accounting changes would raise the outlay and deficit totals stated in the unified budget by about $16 billion in 1982, and eliminate the major portion of off-budget outlays. They would have no effect on the actual state of federal finances, but rather would reflect that state more accurately. [1]

CONCLUDING COMMENTS

Reductions in federal credit activities could be achieved by eliminating programs designed to overcome market flaws where those flaws no longer exist, by eliminating or reducing subsidies, or by targeting subsidies better to reach beneficiaries most in need of credit assistance. The result would be some reduction in unified budget outlays and a substantial reduction of the federal presence in credit markets.

This chapter has stressed that the reason for concern over federal credit programs is not only their budgetary impact but also their broader effect on capital markets. In order to be able to weigh these effects, the Congress needs a framework for deciding upon federal credit activity as a whole, such as is provided by the credit budget. The Congress must be able to hold its several committees accountable for the impact of their individual decisions on total federal credit programs, and to prevent the Administration from taking executive actions at variance with prior Congressional actions, such as the proposed $20.3 billion reduction in 1982 loan guarantee commitments. Full integration of the credit budget into the Congressional budget process would provide that accountability.

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[1] For further discussion of the FFB and possible changes in its budget treatment, see Congressional Budget Office, The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities (January 1982).

APPENDIXES

APPENDIX A. BUDGET REDUCTION OPTIONS

This appendix contains discussions of 69 budget reduction options. Each discussion specifies a potential legislative proposal and then provides an estimated five-year budget savings for the proposal. The major advantages and disadvantages of each proposal are also briefly presented.

The budget savings estimates are all relative to the CBO baseline as published in Baseline Budget Projections for Fiscal Years 1983-1987, February 1982. All estimates are in current dollars. The CBO baseline is not intended to be a forecast of what will happen, but rather it is a neutral baseline of what the federal budget might look like during the next five years if the policies embodied in Congressional budget actions through December 31, 1982, were continued unchanged, and if the economy performed according to the CBO economic assumptions as presented in The Prospects for Economic Recovery, February 1982. Demographic shifts and adjustments to compensate for inflation in discretionary programs are reflected in the baseline.

Most of the budget reduction options in this appendix are referred to under the various budget strategies in the preceding chapters. A few of the options, however, do not appropriately fit under a specific strategy and, therefore, are discussed only in this appendix. The inclusion of an item in the appendix, or its omission, does not imply a recommendation by the Congressional Budget Office. The items presented are simply illustrative examples of ways to cut federal outlays.

The savings estimates given in the items represent only direct budgetary effects in those specific programs and do not include any secondary effects or offsets in other programs. A secondary effect would be, for example, when a large budget reduction lowers real GNP, which in turn increases unemployment and thus federal payments for unemployment compensation. Such a secondary effect is not reflected in the estimates. Similarly, direct offsets on other federal programs, such as the impact of a reduction in the AFDC program on food stamp spending is not reflected.

The savings estimates for the individual options cannot be added to an aggregate total because some of the proposals are alternatives for the same program and because, as just noted, some may have offsets in other programs. Unless specified otherwise, the estimates assume that the proposals under discussion take effect on October 1, 1982. Options that would reduce net outlays, such as increased offsetting receipts, are discussed in this appendix, while those to increase revenues directly are presented in Appendix B.

The options in this appendix are ordered according to the budget function they would affect, beginning with national defense (050) and concluding with two options that would affect all the functions. Each option has an identification code: the A refers to Appendix A; the three digits refer to the budget function number; and the lowercase letter is an ordering within the budget function that, by and large, follows the subfunction sequence in the budget accounts.

ELIMINATE DUAL PAY FOR RESERVISTS WHO ARE FEDERAL EMPLOYEES (A-050-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	47	50	53	57	61	268
Outlays	47	50	53	57	61	268

About 98,000 federal civilian employees who are reservists in the armed forces receive both civilian and military pay during their two-week annual period of active duty for training. They also receive their regular vacation entitlement. Earlier administrations have recommended paying such employees the greater of their civilian or reserve salaries, rather than both. Adopting this initiative would save about $268 million over the next five years. Savings could all be in defense if the change was implemented by reducing reserve pay, or they could be spread throughout the federal budget under other schemes.

Those who favor such a change point out that the dual pay practice is generally not followed by private employers, nor by the federal government itself when a reservist is called up for state duty. Under those circumstances, the employee receives only the higher salary. Moreover, the practice may attract disproportionately large numbers of federal employees to the reserves, despite the greater likelihood that their civilian jobs would excuse them from a military mobilization. The counterargument is that the change could have an adverse effect on recruiting and retention of reserves--in a force already falling short of its enlisted manning goals. (If the Congress limited the change to officer reservists--who are not in short supply--the savings over the next five years would still amount to about $100 million relative to the CBO baseline.)

PHASE IN OVER THE NEXT THREE YEARS THE "HIGH-3" RETIREMENT BENEFIT CALCULATION FOR ALL MILITARY PERSONNEL
(A-050-b)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	1	27	75	141	216	460
Outlays	1	27	75	141	216	460

Traditionally, military retirement benefits have been calculated as a percentage of the individual's basic pay on the day of retirement. In 1980, the Congress decided instead to base military retirement on average pay during the three years when it was highest, the same procedure used in calculating federal civilian retirement annuities. The change, however, applied only to new recruits. Thus, it will take many years before significant savings appear.

This option would accelerate the change by phasing it in over the next three years. Under this approach, all those who retire within 36 months of the date of enactment would base their retirement on average basic pay during the months since enactment. Those who retire thereafter would have their retirement benefit calculated on the average of the three years of highest basic pay.

CBO estimates that this change in computing retirement benefits would save $460 million over the next five years. Opponents of such change argue, however, that any such reduction in benefits will adversely affect military retention. (CBO estimates suggest an overall reduction of about 3 percent in enlisted retention and about 4 percent in officer retention.) Opponents also point out that it represents an inequitable treatment of military personnel who served with the understanding that their retirement benefits would not be downgraded once they committed themselves to a military career.

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REDUCE COST-OF-LIVING ALLOWANCES FOR WORKING-AGE MILITARY RETIREES (A-050-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	162	459	764	1,056	1,331	3,772
Outlays	162	459	764	1,056	1,331	3,772

The military retirement system provides benefits for 1.4 million persons at a cost of about $15 billion in fiscal year 1982. Most military retirees are relatively young when they begin drawing their benefits; for example, the average age of nondisability active-duty retirees in 1980 was 45.4 in the case of officers and 41.6 for enlisted retirees.

This option would provide half the regular cost-of-living increase for retirees under age 60, with a catch-up raise at age 60 to make up for the half raises. Proponents of such an approach would argue that younger retirees, most of whom would be working in second careers, need less protection from inflation than their older nonworking counterparts. Such a shift would also lessen the incentive to leave the military after serving less than a full career of 30 years or more. Opponents of such a change might well argue that any reduction in future retirement benefits would adversely affect career decisions by those short of retirement eligibility. Indeed, other incentives, such as greater use of reenlistment bonuses, may have to be adopted to offset negative retention effects in key skills. Without considering the increased cost of reenlistment bonuses, however, CBO estimates that the cumulative five-year savings under this option would be about $3.8 billion.

The estimate of savings assumes that changes under this option are made for all retirees at the beginning of fiscal year 1983. If the Congress "grandfathered" or protected from any reductions all of today's retirees, there would be little or no savings over the next few years; if it protected all those now on active duty as well, the savings would not begin until the twenty-first century.

INCREASE INTEREST CHARGES ON BILATERAL DEVELOPMENT LOANS (A-150-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	5	40	96	164	235	540
Outlays	5	40	96	164	235	540

The United States makes loans to developing countries through functional assistance programs, through Title I of Public Law 480 (food aid), and through the Economic Support Fund. In 1981, functional assistance loans amounted to $410 million, food aid loans to $674 million, and Economic Support Fund loans to $274 million, for a total of $1.4 billion.

Savings might be achieved by reexamining the interest-rate subsidy in these programs. Since the Foreign Assistance Act specifies only the minimum allowable rates, the President could decide to raise the rates charged on bilateral loans without explicit action by the Congress. Alternatively, the Congress could legislate a formula tying rates to an assisted country's income level. At present, the following interest rates apply to most borrowing countries: 2 percent during implementation of a project, when only payments of interest are made; and 3 percent once the project is operating, when payments of both interest and capital are required. On loans made in 1981, each percentage point increase in the interest rate could produce savings of up to $14 million annually. Since interest rates cannot be increased on outstanding loans, savings would accumulate over time. For example, if the average interest rate on development loans was increased to 8 percent, savings would be $5 million in 1983, and $540 million over the next five years.

Proponents of such interest-rate increases argue that when these loan programs were initiated they involved smaller subsidies because market interest rates were lower. In many cases, changes in economic conditions rather than policy actions have determined the degree of subsidy in these loans.

At the same time, the size of the interest subsidy might be varied according to the income levels of recipient countries. Currently, the same interest rates apply to most borrowing countries, although the payback period on loans can be varied. A restructuring of interest rates by income level would produce savings, for a given distribution of loans, to the extent that the average interest rate on the loans increased.

Opponents of these proposals argue that current interest rates reflect the desired quantity of total U.S. foreign aid. Increased interest rates on development loans would reduce the quantity of aid provided, and therefore might lead to increased funding for other foreign aid programs. Those who oppose varying the degree of interest subsidy according to the incomes of recipient countries argue that development projects tend to help the poorest people within the middle-income developing countries. To increase interest rates for these countries, they maintain, would be contrary to U.S. foreign policy objectives.

END PUBLIC LAW 480 TITLE I SALES
(A-150-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	813	835	879	922	959	4,408
Outlays	813	835	879	922	959	4,408

Under Title I of the Agricultural Trade Development and Assistance Act of 1954 (Public Law 480), the United States lends at below-market interest rates to finance foreign purchases of U.S. agricultural commodities. New loans and direct expenditures for items such as ocean transportation totaled $850 million in 1981. New spending authority in 1982 is $803 million.

The Congress enacted the Title I program when there were large domestic agricultural surpluses that could not find markets abroad, in part because of difficulties in converting foreign currencies to dollars. During its first decade, the program financed between one-quarter and one-third of all U.S. agricultural exports. But as surpluses have dwindled and currency convertibility has become less of a problem, Title I sales have fallen in importance relative to commercial agricultural exports; in 1980, Title I sales accounted for only 5 percent of total agricultural exports of $18.1 billion.

The Congress could decide to end the Title I program, while continuing humanitarian food aid programs through Title II sales. This change in policy could result in savings of about $4.4 billion in outlays over the next five years.

Some favor ending this program because many of its original justifications no longer exist. Some also suggest that the continuance of subsidized sales may undermine long-run U.S. interests, in that artificially cheap food discourages local investment in agricultural production and the building of local stockpiles of commodities.

On the other hand, concessional sales through Public Law 480 provide the Administration with a flexible foreign policy tool helpful to U.S. national security. About half the dollar volume of sales in the 1981 allocation is to countries also receiving assistance through the security-oriented Economic Support Fund and foreign military sales credits. Savings from the elimination of the Public Law 480 account might be offset by increases in the security assistance accounts for these countries.

CHARGE MARKET INTEREST RATES ON EXPORT-IMPORT BANK DIRECT LOANS (A-150-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	2	15	55	118	183	373
Outlays	2	14	51	108	167	342

The Export-Import Bank (Eximbank) has a direct loan program that assists U.S. exporters by lending at subsidized interest rates to foreign purchasers of their products. The program supported about 2.4 percent of total 1980 exports. The Congress has limited Eximbank's 1982 new direct lending authority to $4.4 billion, down from $5.5 billion in 1981. If Eximbank charged a market interest rate instead of a subsidized interest rate, there would be savings of $2 million in 1983 and $342 million over the next five years. The volume of direct loans would also decline, further contributing to a decrease in outlays, although this reduction is not reflected in the estimates.

Currently, Eximbank charges 10.75 percent on nonaircraft loans, while the rates charged on comparable loans in the private market vary between 13.6 percent and 14.2 percent. 1/ In 1980, the total subsidy ranged between $200 million and $1 billion. Proponents of ending the subsidy argue that charging market interest rates would increase economic efficiency. They argue, moreover, that the current interest subsidy goes either to foreign importers in the form of lower interest rates or to U.S. exporters to the extent that they are able to charge higher prices. Because efficiency falls and foreign importers probably receive some benefit, the United States as a whole and nonsubsidized U.S. citizens as a group lose from this program's operation. 2/

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1. Eurodollar and U.S. AAA corporate bond rates, December 1981.

2. Congressional Budget Office, "The Benefits and Costs of the Export-Import Bank Loan Subsidy Program" (June 1981).

Some argue against adopting this proposal on the ground that doing so would lead to higher unemployment. While ending the Eximbank interest subsidy would probably reduce profits in some exporting industries, particularly among commercial airframe and commercial nuclear powerplant manufacturers, it is not clear that it would reduce employment significantly in these industries because the effect of Eximbank's lending on the volume of exports is uncertain. Furthermore, any increase in output and employment attributable to the program may only occur at the expense of lower output and employment in unsubsidized sectors of the economy.

TERMINATE THE SOLVENT REFINED COAL-I (SRC-I) DEMONSTRATION PLANT (A-270-a)

	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
Savings a/	1983	1984	1985	1986	1987	
Budget Authority	145	155	170	180	190	840
Outlays	40	100	150	160	175	625

a. This savings estimate is based on the Department of the Interior and Related Agencies Appropriations Bill, 1982 (P.L. 97-100), which indicated Congressional intent to continue funding SRC-I. The CBO baseline, on the other hand, includes only $40 million in budget authority for fossil energy demonstration plants between 1983 and 1987, based on the authorization ceilings in the 1981 reconciliation act.

The Solvent Refined Coal Demonstration Plant is part of a program initiated in 1978 to design, construct, and operate full-sized commercial synthetic fuel plants to convert coal into more easily used fuels. Of five demonstration projects begun in the late 1970s, only the SRC-I plant, slated for Newman, Kentucky, remains. These five projects had been authorized at various levels totaling approximately $900 million by the beginning of 1981. In March 1981, however, President Reagan recommended terminating Department of Energy participation in these projects and turning over all federal synthetic fuels demonstration activities to the Synthetic Fuels Corporation. These actions, coupled with a mutual agreement among the cost-sharing participants in the SRC-II project, have effectively shut down all the projects except SRC-I.

The design of SRC-I is about one-third completed, at a cost of about $100 million through 1981. The Administration requested no funds for 1982; while the Congress provided no new budget authority, it did direct that $135 million deferred from 1981 be spent on completing the design. Continuing SRC-I to an operational stage is estimated to cost $1.5 billion. Termination would save about $625 million between 1983 and 1987, relative to a projection of the 1982 spending level.

Since the recent decontrol of oil prices, the energy market can better indicate which alternative energy sources are economic to produce. These signals should allow private energy developers to choose among investment alternatives without federal direction. Therefore, if the appropriate role for federal research and development programs is to transfer newly developed technologies to industry for commercialization, federal support for SRC-I could be eliminated.

In addition, although the SRC-I project might produce some unique technical advances in fuel-burning characteristics and environmental controls, smaller pilot plants might present more cost-effective demonstrations. Further, cutting the direct federal funding for the project would force developers interested in the process to commit more of their own funds and compete for capital in the marketplace. This should enhance the chances of choosing the most promising technologies for commercialization within the synfuels industry.

If the project is discontinued, however, these potential technical advances might not be realized, or might take much longer to achieve. Further, a reduced financial commitment from the government might cause the industry to proceed more slowly in developing synfuel technologies, resulting in continued reliance on potentially insecure foreign sources of oil and the large dollar outflows associated with high levels of imported oil.

TERMINATE THE CLINCH RIVER BREEDER REACTOR
(A-270-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	210	220	240	250	270	1,190
Outlays	200	215	220	240	260	1,135

The Clinch River Breeder Reactor (CRBR) was originally intended to demonstrate that a liquid metal, fast breeder reactor could be operated safely and reliably to provide electricity for public utilities. Breeder reactors are nuclear reactors that produce more fuel than they consume. The commercialization of breeder reactors could contribute to increased opportunities for theft and diversion of nuclear materials, proliferation of nuclear weapons, and nuclear accidents. Also, the future need for breeder reactors and their economic efficiency are unclear. Termination of CRBR, which accounts for about one-third of 1982 federal breeder reactor costs, could save approximately $1.1 billion between 1983 and 1987.

Although originally portrayed as the flagship of the U.S. breeder reactor program, CRBR has been the subject of great debate and numerous budget controversies. CRBR has suffered from serious cost escalation (the current estimated total cost of over $3 billion is more than four times the 1972 estimate of $700 million), allegations of waste and abuse, and technical uncertainties. Further, some authorities consider the design to be outdated and unnecessary. France, which has devoted major efforts to develop breeder reactors, appears to be in a better position to proceed with commercial development. The possibility of licensing the French design bolsters the argument for terminating CRBR.

Some experts, on the other hand, continue to cite CRBR as a prudent and essential step in the breeder reactor research and development program. Terminating the project, however, would not necessarily imply permanent rejection of the U.S. breeder reactor program. In addition to the $195 million earmarked for CRBR in 1982, the Congress appropriated about $400 million for continued research and development in other breeder reactor programs. Consequently, even if CRBR is abandoned, ongoing research may eventually demonstrate the value of a successor commercialization project.

FINANCE NUCLEAR WASTE PROGRAMS WITH SURCHARGE ON NUCLEAR POWER GENERATION
(A-270-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	225	250	275	300	325	1,375
Outlays	225	250	275	300	325	1,375

Nuclear power plants produce highly radioactive spent nuclear fuel that can be reprocessed to capture reusable uranium. Until recently, reprocessing was prohibited in this country as part of a national policy to discourage the proliferation of nuclear materials. With the future use of reprocessing still uncertain, the spent fuel must be disposed of as waste. In 1982, the government will spend about $200 million on research to determine the best means and places to dispose of the spent fuel. The Congress is now considering legislation that would lead to the construction of repositories. It is estimated, however, that repositories will not be ready until nearly 2000.

Since consumers of nuclear-generated electricity primarily benefit from the nuclear waste program, it might be appropriate for these consumers, rather than all taxpayers, to pay for current research and development (R&D) and future construction of disposal facilities. A surcharge of about one-half mill per kilowatt hour on nuclear-generated electricity would raise enough funds for continued R&D activities through the early 1990s. This would increase the average consumer's electricity price by less than 1 percent, while providing additional receipts of about $1.4 billion during the 1983-1987 period. If the Congress authorizes construction of disposal facilities, the increased spending levels would require a higher fee.

Such a surcharge would recover the costs of the nuclear waste programs from the beneficiaries and might improve efficiency in utility companies' decisionmaking. It would, however, raise prices for consumers and contribute to inflation. The timing and degree to which the surcharges were passed on to consumers would vary, depending on the form of the surcharge and its treatment by individual state public utility commissions.

PRICE URANIUM ENRICHMENT AT FAIR-MARKET VALUE (A-270-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	12	0	98	131	175	416
Outlays	525	600	660	665	700	3,150

In order to function, the light water reactors generally used in U.S. nuclear power plants require more U-235 than is found in natural uranium. The process that increases the U-235 content is called uranium enrichment. The U.S. government provides this enrichment service for all domestic and some foreign utilities, accounting for about 72 percent of free-world enrichment activities in 1980.

Currently, the government does not charge as much for the enrichment service as private firms would. The government is permitted by law to recover only its historic costs, whereas private businesses routinely cover the costs of taxes, insurance, and a return on equity in their charges. The Department of Energy (DOE) estimates that this cost recovery policy has provided a cumulative subsidy of $5.5 billion (in 1979 dollars) to the nuclear industry over the 1954-1980 period.

The federal government usually does not charge the equivalent of private-sector prices for its services, because most of them are provided in areas in which private firms could not operate. In uranium enrichment, this is not the case. The government retains its monopoly for national security reasons rather than because private firms could not profitably perform the enrichment services. Thus, fair-market pricing for uranium enrichment warrants consideration. Imposing a fair-market price for enrichment services could increase costs to the purchasing utilities by roughly 31 percent during 1983-1987, generating additional revenues (or outlays savings) of $3.2 billion.

Proponents contend that such a pricing shift would promote efficiency and reduce the uranium enrichment program budget. These savings are also contingent, however, upon the pricing policy of DOE's competitors. Recently, its major European competitor, Eurodif (a consortium including France, Italy, Belgium, and Spain), dropped its price significantly to compete with the anticipated 1982 DOE price. The estimated savings assumes that, if the Congress enacted a fair-value price, Eurodif would raise its price to about the same level. Critics of fair-value pricing contend that this would not happen and that such a policy would undermine DOE's competitiveness in the long run as European competition continued to price below cost. Opponents also argue that this could encourage the proliferation of nuclear weapons as the United States loses its dominance in providing enrichment services.

In the short term, the United States might want to retain its market share of enrichment services by maintaining its present pricing policy. Over the long term, if European competitors persevered in price-cutting below costs, the U.S. government might question the wisdom of providing these enrichment services.

CUT SUBSIDIES FOR SYNTHETIC FUELS
(A-270-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	0	0
Outlays	34	36	37	39	40	186

Synthetic fuels, which are substitutes for oil and gas products, are produced by processing plentiful resources such as coal and oil shale. The Synthetic Fuels Corporation (SFC), an independent federal entity, was created in 1980 to assist the private sector to develop a number of commercial-sized synthetic fuel plants. The SFC, with $12.2 billion in budget authority granted before 1983, functions primarily as an investment bank. It is authorized to provide loan guarantees, price guarantees, purchase agreements, and direct loans. In exceptional circumstances, the SFC may participate in joint ventures with private firms.

If the Congress decided to abolish the SFC, the potential outlay savings would probably amount to only $186 million during 1983-1987. Because it concentrates on financial arrangements that require little or no outlays unless projects fail, the short-term outlays should be relatively low, although the government would remain exposed to potential high costs. Since synfuel projects require a number of years to build, large budget outlays caused by project failure or default are not likely to occur until after 1987. The exact impact cannot be calculated, since there is no basis on which to predict how the SFC will allocate financial assistance among the available options and what the failure and default rates might be.

The purpose of the additional production from SFC-assisted synthetic fuel plants is to make the U.S. economy less vulnerable to potential interruptions of imported oil and to assist the U.S. transition to alternative fuels to offset declining domestic oil and gas reserves. The SFC was first suggested during a period when domestic oil prices were controlled at below market value. Controlled crude oil prices limited the market's ability to give correct signals about the potential competitiveness of synthetic fuels, thus reducing the incentives for developers to proceed. With the recent decontrol of oil prices and the scheduled deregulation of natural gas prices by 1985, market forces rather than government regulation will probably determine investment decisions about commercial development of synthetic fuels. Under these circumstances, the SFC might no longer be needed.

On the other hand, since the SFC fosters synthetic fuel development, it might provide some additional insurance against the effects of a future interruption in foreign oil supplies. SFC proponents contend that such insurance outweighs the possible inefficiencies that might result from SFC subsidies. They also argue that the United States will have to make the transition to synthetic fuels eventually, and therefore, the experience provided by early plants will be helpful in choosing the appropriate technologies.

REDUCE REA INTEREST SUBSIDIES AND TARGET REA LENDING MORE EFFICIENTLY
(A-270-f)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority (Off-budget)	300	700	1,400	2,000	2,600	7,000
Outlays (Off-budget)	300	700	1,400	2,000	2,600	7,000

The Rural Electrification Administration (REA) was created to spur development of electric and telephone service in rural areas. This goal has been fulfilled--99 percent of the nation's farms now have access to electricity and 95 percent to telephones. The REA, however, continues to support the financing activities of utility cooperatives located primarily in rural areas, lowering their costs of building new generating plants and transmission and distribution networks. In areas that have changed from rural to urban, utilities are still eligible for REA assistance, as are rural utilities that charge electric rates below the national average.

The REA provides loans to rural electric and telephone cooperatives through a heavily subsidized direct loan program and a loan guarantee program that is essentially a direct loan program funded through the Federal Financing Bank (FFB). Direct REA loans are made at 2 or 5 percent interest for terms of up to 35 years, while REA-guaranteed FFB direct loans are made at a rate marginally higher than the long-term Treasury borrowing rate and for terms of up to 35 years.

For 1982, the Congress has specified that REA make minimum commitments of $1.1 billion in direct loans and $5.1 billion in guaranteed loans. These levels will bring cumulative commitments for REA direct loans to $16.9 billion and for loan guarantees to $31 billion by the end of 1982. Over the next five years, the FFB is expected to fund over $25 billion in REA-guaranteed loans. This amount is almost as large as the total on-budget expenditures for energy activities. It is twice the amount authorized for the

Synthetic Fuels Corporation, and also exceeds federal spending for the Strategic Petroleum Reserve.

Possible ways to reduce the substantial federal off-budget outlays for REA activities include increasing the interest charged on direct loans and reducing annual guaranteed loan commitments to one-half the level that would be provided under current Congressional allocations. These two proposals would decrease federal off-budget outlays by about $7 billion over the 1983-1987 period.

The argument for increasing interest rates on direct loans centers on the cost of providing credit at rates significantly less than the government itself must pay and the fact that the relative subsidy provided by these interest rates has grown significantly since it was first enacted. At present interest rates, every $100 million in direct REA loans will cost the government about $215 million over the life of the loans. Increasing interest charges to three percentage points below Treasury borrowing costs would reduce federal costs by over $300 million between 1983 and 1987, while still providing borrowers with access to credit at rates substantially less than private market rates, under favorable loan terms, and with significant savings in lending costs.

A reduction in the loan guarantee level would be aimed at ensuring that limited credit resources were allocated to the most effective and essential uses. Virtually all of the REA guarantees apply to loans for electric transmission and generation facilities. No other energy function receives such unrestricted access to federal financing. The ranges imposed by the Congress are set to accommodate the upper limits of the cooperatives' projections of their power supply needs. The REA guarantees are not contingent upon the types of planning and efficiency criteria required of other federal power projects, most notably those included in the 1980 Pacific Northwest Power Planning and Conservation Act (PNPPCA).

While the credit market would function most efficiently if the cooperatives were required to use private-sector financing in lieu of federal guarantees, equity and national goals for power and telephone capacity may support the retention of some federal assistance. As an alternative to an abrupt termination of the REA loan guarantee program, lending could be focused on projects meeting efficiency criteria, and loan guarantees reduced to a level that would serve only those projects that most clearly support national goals. For example, a 50 percent reduction in guarantee commitments would reduce off-budget outlays by $6.7 billion over the next five years.

Several options are available to achieve greater efficiency in the REA loan guarantee program and thus limit the adverse effects of funding reductions. One approach would be to reduce the demand for federal lending by increasing the interest rate charged by the FFB for the guaranteed loans. Another option would be to use a more competitive selection process in extending guarantees. Competition could be based on planning, conservation, and management standards similar to those required for the Bonneville Power Administration under the PNPPCA. Alternatively, the REA guarantee program could be modeled after the approach taken in the Energy Security Act. Eligibility criteria also could be tightened according to the types of borrowers or facilities.

A decrease in the interest subsidy for REA direct loans is likely to increase electricity and telephone costs to consumers served by cooperatives. The magnitude of this increase will depend on the government's long-term borrowing rate and on the debt structure of the cooperatives. Decreasing loan guarantee levels might increase the price and limit the availability of electric and phone service, because cooperatives would be more dependent on private-sector financing for meeting future load growth.

INCREASE PRICE OF BUREAU OF RECLAMATION IRRIGATION WATER
(A-300-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	22	47	73	101	132	375
Outlays	22	47	73	101	132	375

The Reclamation Act of 1902 established the Bureau of Reclamation to administer development of arid and semiarid lands in 17 western states. Most of the bureau's projects have been designed primarily to provide water for agricultural irrigation. Of the 30.1 million acre-feet of water delivered to users by the bureau in 1979, 93 percent was sold for irrigation. Instead of setting user fees for irrigation water on its cost, the government bases fees on the users' ability to pay and/or on a percentage of original construction costs without interest. In 18 major projects, the bureau sells water at an average price of $9.34 per acre-foot, while the average cost for these deliveries is about $58.00 per acre-foot.

If the price of this water was gradually raised until users paid the full cost, receipts would increase by $132 million in 1987. For example, in the lower Yellowstone project, the bureau now sells water at $5.28 per acre-foot. The estimated full cost of this water is $34.62 per acre-foot, and energy industries in the region would pay from $200 to $500 per acre-foot for the same water.

Proponents of full-cost pricing contend that the subsidy promotes inefficiency, indirectly causing water scarcities. According to the General Accounting Office, the government's full costs of delivering water often exceed the added income that irrigation brings farmers. Opponents assert that western agriculture has developed because of subsidized water prices and that full pricing would require a major adjustment by users; thus any policy to cancel the subsidy should be phased in slowly to let farmers convert to less water-intensive methods. Others contend that, because the subsidy's benefits are widespread, they are in the public interest.

ALLOCATE FEDERAL GRAZING RIGHTS AT MARKET RATES
(A-300-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	3	9	17	25	33	87
Outlays	3	9	17	25	33	87

Several federal agencies allow grazing on land under their jurisdictions. Two of these--the Department of Defense (DoD) and the Bureau of Indian Affairs (BIA)--receive market values for the grazing rights by auctioning them. The agencies with the largest land-holdings--the Forest Service and the Bureau of Land Management (BLM)--allocate grazing rights by permit, and are required by law to collect fees based on beef cattle prices, forage values, and other costs associated with raising cattle. These grazing fees have not been as high as nearby commercial rates or bids made for comparable grazing on DoD or BIA land.

The Forest Service and BLM collected about $38 million in 1981 in grazing fees, at the rate of $2.30 per animal unit per month (AUM). (Comparable private rates vary from $5 per AUM to $12 per AUM.) If new legislation required these grazing rights to be auctioned by sealed bid (with the required minimum designated at the currently legislated fee) rather than allocated by permit, the average fees could more than double, and the annual revenue gain would be about $33 million in 1987. This assumes that, by 1987, 80 percent of all permits would be auctioned and half of those auctioned would be sold at rates approximating those on DoD and BIA land. The other half are assumed to sell at rates just above the current regulated price.

Proponents claim that market rates established by auctioning grazing permits would not only pay for a larger part of the costs of public range management, but would also give better signals to federal officials of the relative values of land parcels under their management. Furthermore, some believe that much western land is overgrazed because the permit costs are relatively low. Market rates would balance use of land with the land's capability to provide food.

Defenders of the current arrangements assert that permit fees represent fair value, considering the deteriorated condition of much public land from overgrazing. Further, the present holders of grazing permits have arranged their business affairs in the belief that current practices will be continued. Opponents of this change contend that the disruption caused by auctioning permits would be unfair to these holders.

CHANGE FEDERAL-STATE SHARE OF MINERAL RECEIPTS
(A-300-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	146	159	175	192	207	879
Outlays	146	159	175	192	207	879

Federal gross receipts from bonuses, royalties, and rentals resulting from development of onshore mineral resources on public domain lands totaled approximately $750 million in 1981 and may increase considerably in future years. These receipts are shared with the states containing the public lands, with 90 percent for Alaska (except 50 percent from the National Petroleum Reserve) and 50 percent for all other states. Before the law was changed in 1976, the share for states other than Alaska was 37.5 percent.

The Congress could increase net federal receipts by about $900 million over the 1983-1987 period by reducing the share for all states to the former 37.5 percent. The major reason for such a proposal is that the federal government bears substantially more of the costs of producing the resource than do state governments. 1/

States oppose this change principally because of the costs to them of rapid energy development. Because energy development on federal land often occurs near nonfederal land, some costs spill over to adjacent areas and are borne by state and local governments. In addition, state and local governments may have cash flow problems because they may experience significant preproduction expenses but do not receive payments until the resource is produced.

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1. It is also true that the current net federal share is most likely less than 50 percent because of revenue losses resulting from the tax deductibility of resource payments. Because the marginal rates of those making payments are much higher for federal than for state taxes, the federal share of net receipts, after tax effects are considered, is much lower than the state share. Reducing the state share of gross receipts to 37.5 percent would produce about a 50-50 split of net receipts.

INCREASE ENTRY CHARGES FOR OUTDOOR RECREATION AREAS (A-300-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	30	60	94	97	100	381
Outlays	30	60	94	97	100	381

Federal recreational areas have more than 800 million visitors each year. In 1980, fewer than 5 percent of these visitors paid entrance fees, producing net revenues of only $5 million (after collection costs were deducted), compared with annual costs of about $350 million simply to maintain the visited areas. On the average, visitors who paid fees in 1980, paid less than 20 cents per person to enter federal recreational facilities. If the Congress increased these entry fees to an average of 60 cents per person (after collection costs) and required the responsible agencies to collect fees from 20 percent of all visitors, net receipts would increase by about $100 million in 1987.

It is impractical to collect entry fees at many federally owned natural areas; in some remote areas, collection costs would exceed receipts. At most dams or water impoundments and the traditional national parks, however, entry fees are feasible and cost-effective. Similar facilities managed by states or municipalities routinely charge entry fees in order to recover costs of services. The park system in Canada is financed in large part through entry fees.

Opponents of proposals to increase or extend park entry charges make several points. They argue that a major purpose of the national parks is preservation of a unique resource for future generations, and that the cost of this should be borne by all taxpayers. They also assert that a price cannot and should not be put on the value of access to the Grand Canyon and similar national treasures. On the other hand, the recreational agencies are spending about $350 million per year to maintain recreational facilities for visitors. Increasing entry fees would defray a part of these costs.

REDUCE FUNDING FOR EPA CONSTRUCTION GRANTS (A-300-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	200	200	1,040	1,095	1,155	3,690
Outlays	0	20	70	230	500	820

Municipalities have received federal grants to construct wastewater treatment plants under various authorizations since 1957. The Federal Water Pollution Control Act Amendments of 1972 considerably expanded this program by requiring the Environmental Protection Agency (EPA) to provide 75 percent of the allowable construction costs for approved projects. The Clean Water Act of 1977 authorized EPA to fund 85 percent of projects using alternative or innovative technologies. In recent years, outlays have been around $4 billion annually.

In 1981, the Congress significantly modified the program. The 1982 authorization level was lowered from $5.0 billion to $2.4 billion, with $2.6 billion authorized annually for 1983 through 1985. Of this $2.6 billion, $200 million was reserved annually for combined sewer overflows into marine bays and estuaries.

In 1985, three other program changes will be implemented. First, only 20 percent of a state's allotment can be spent on major rehabilitation of sewers, new collector sewers, and combined sewer overflow. Second, projects must be designed only for current population needs, rather than for anticipated future growth. Finally, the federal share of the construction costs will be reduced from 75 to 55 percent.

To obtain additional savings, the Congress could make further program changes. Large savings would result from further reducing the federal share of construction costs--for example, from 55 percent to 45 percent--with corresponding reductions in budget authority, and by eliminating entirely the funds for major rehabilitation of sewers, new collector sewers, and combined sewer overflow. (Under current law, beginning in 1985 governors would be allowed to use up to 20 percent of a state's allotment for these otherwise ineligible projects.) These two changes could be implemented by decreasing budget authority 35 percent annually beginning in 1985. Budget authority could be cut by another $200 million annually, beginning in 1983, if the authorization for combined sewer overflow into marine bays and estuaries was eliminated. Removing the current two-year time limit on obligation of funds would save smaller amounts. Together, these proposals would reduce budget authority and outlays by $3.69 billion and $820 million, respectively, over the 1983-1987 period.

These changes could improve the program's efficiency in several ways and thereby partially offset their effect on water quality. First, larger state or local contributions to capital costs would reduce the potential incentive to build overly expensive and sophisticated treatment plants. Second, eliminating funds for several categories of projects would concentrate resources on those that contribute most to improving water quality. Third, removing the time limit on obligation of funds could eliminate the possibility that many projects funded at the end of the obligational period are those "ready-to-go," rather than those of higher priority, but not yet ready for funding.

Critics of these changes present several arguments. The recently enacted cut in the federal share from 75 to 55 percent (effective in 1985) may adequately discourage municipalities from building overly sophisticated plants, and perhaps some experience should be gained with the 55 percent share before further reducing it. Although major rehabilitation of sewers, new collector sewers, and combined sewer overflow may generally be less deserving of funding than treatment projects, this may not be true in every case. It might be better to leave some discretion to the states. Further cuts in the federal share and elimination of eligibility for certain projects would increase the financial burden on state and local governments beyond those likely to result from recently enacted program changes. Funding level decreases of the magnitudes suggested here would leave most states with annual allotments of $20 million or less, which is very modest compared with an average project cost of $15 million. Finally, the current two-year time limit on obligation of funds results in the reallocation of unobligated funds to other states. By eliminating the time limit, money would be allocated solely by an allotment formula that might not correspond to the most efficient distribution of funds.

ELIMINATE FmHA FARM LOAN INTEREST SUBSIDIES
(A-350-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	51	94	115	127	387
Outlays	0	51	94	115	127	387

The Farmers Home Administration (FmHA) makes farm ownership and operating loans at subsidized interest rates to limited-resource farmers. Limited-resource farmers are identified by FmHA as: (1) beginning farmers having adequate training or farm experience but lacking sufficient resources to enter farming; (2) farmers adjusting their operations by buying farmland or changing enterprises, and farmers requiring loans to remain in business; and (3) disadvantaged farmers with serious deficiencies in resources, income, credit, education, and living standards. Currently, limited-resource borrowers are charged 11.5 percent for farm operating loans and 7 percent for farm ownership loans, as compared with 14.5 and 13.25 percent charged to regular borrowers. Since the limited-resource loan program was begun in fiscal year 1979, FmHA has loaned about $1.5 billion to nearly 32,000 limited-resource farmers. Current law requires that at least 25 percent of FmHA's farm loans go to such borrowers. In addition, FmHA makes emergency disaster loans to farmers unable to obtain credit elsewhere; these loans carry an interest rate of 8 percent--about half of FmHA's cost of obtaining the funds it is lending. Eliminating interest subsidies on both the limited-resource farm loans and the emergency disaster loans would save a total of about $387 million over 1983-1987.

The principal objective of the limited-resource loan program is to assist low-income farmers to increase their production, income, and living standards. While there may be other reasons for public financing of limited-resource farmers, this activity does not result in any measurable increase in production. Thus, interest subsidies could be eliminated without detriment to the nation's long-term food and fiber production capacity.

Clearly, there are high entry and expansion costs in farming. The elimination of FmHA interest subsidies would mean that some persons would have to leave farming and others who want to become farmers would not be able to do so. On the other hand, there is much uncertainty about the potential for limited-resource borrowers to become financially independent of FmHA.

FmHA also makes emergency disaster loans to farmers at highly subsidized interest rates when applicants are unable to obtain credit elsewhere. If a farmer is in fact creditworthy, there is no policy reason to charge less than FmHA's own borrowing costs; and if he is not creditworthy, the case for making any loan at all is weak. Further, the availability of such subsidized disaster aid discourages participation in the federal crop insurance program, which charges a premium to participants.

REDUCE THE LEVEL OF DAIRY PRICE SUPPORT
(A-350-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	0	900	1,300	1,600	3,800
Outlays	900	1,300	1,600	1,600	1,600	7,000

The federal government supports the price of milk by purchasing manufactured dairy products. The current support price is $13.10 per hundredweight of milk. Under the Agriculture and Food Act of 1981, the minimum level of milk price support must rise to $13.25 on October 1, 1982, to $14.00 a year later, and to $14.60 on October 1, 1984. For 1983, 1984, and 1985, these price support levels are about 68, 67, and 65 percent of parity, respectively. 1/ Under certain conditions, the minimum level of support rises to 70 or 75 percent of parity.

The dairy price support program has increased farm milk prices at the expense of consumers and taxpayers, but it has also helped to stabilize the dairy industry, resulting in an assured supply of milk and dairy products. In the past two years, however, milk price supports have been at a level that has contributed to a sharp expansion in milk production. In fiscal year 1981, the commercial supply of milk exceeded commercial use by about 10 percent, with all the excess purchased by the federal government at a cost of almost $2 billion.

There appears to be small prospect of commercial milk supply coming in line with consumption by 1986, because the 1981 legislation continues to give dairy farmers the signal to increase production. Thus, federal dairy price support outlays are projected to remain relatively high under current policy.

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1. Parity is the price, in current dollars, that gives milk the same purchasing power per unit in terms of goods and services bought by farmers as prevailed in the base period, January 1910 to December 1914.

The costs of this program will not decline unless milk production more nearly matches the demand for milk. One option would be to bring about a total 15 percent reduction in the current level of support in four six-month intervals beginning April 1, 1982--a decline from $13.10 per hundredweight of milk to $11.10 per hundredweight beginning in fiscal year 1984.

Such an approach would provide an orderly adjustment process with a predictable decline rather than a predictable increase in support levels. As compared with current policy, it would cause annual average farm prices of milk to be about 15 percent lower during 1983-1985, and annual milk production to average about 5 percent less. Lower farm prices would reduce average consumer prices for milk and dairy products by about 8 percent compared with current policy. Consumption, therefore, would average about 1 percent more per year. Because of reduced production and increased consumption, government purchases would decline, resulting in savings of $0.9 billion in 1983 and about $7 billion over the 1983-1987 period.

This option would cause dairy farmers to experience a real loss of income. During 1983-1985, dairy farmers' annual cash receipts would average about 20 percent less than under current policy. Such a sharp decline would likely cause some farmers to leave the industry. It might also lead to more volatile prices, since milk supply and demand would be in close balance by 1986; there is evidence that milk supplies and prices are more volatile when government purchases are less than 2 percent of annual milk production. To reduce the risk of an unstable dairy sector and higher prices to consumers, it might be necessary to increase the level of price support slightly after three years.

ELIMINATE FARM DEFICIENCY PAYMENTS
(A-350-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	0	250	0	0	250
Outlays	250	0	0	0	0	250

NOTE: CBO projects no deficiency payments over 1984-1987, but under a less favorable farm price scenario annual payments could reach $4 billion.

In the mid-1960s, U.S. policy began to shift away from high domestic price supports and rigid supply controls, allowing domestic grain and upland cotton prices to adjust gradually to world price levels. Payments were made to assist farmers in this adjustment. From the mid-1960s to the early 1970s, income payments--which averaged $3 billion annually--were an important part of crop farmers' incomes. In the mid-1970s, deficiency payments--based on differences between target prices and market prices--were authorized for wheat, feed grains, upland cotton, and rice as a replacement for payments not tied directly to market prices.

In crop years 1974 through 1980, a total of about $2.5 billion of deficiency payments was made. About $1 billion of deficiency payments were made in crop year 1981 as a result of higher target prices, low crop prices, and because more farmers participated in the programs. Deficiency payments are highly concentrated among larger farmers and are of small economic consequence to most.

The Food and Agriculture Act of 1981 continues deficiency payments for the 1982-1985 crops. While CBO's baseline projection shows no deficiency payments for most of that period, a fall in farm prices could trigger payments of up to $4 billion annually.

Given the evolution of agricultural policy, deficiency payments have largely fulfilled their function and could now be eliminated without detriment to domestic agriculture. Other provisions of existing commodity programs--the farmer-owned grain reserve, crop loans, and acreage diversion payments--could be used, if needed, to prevent large drops in crop farmers' incomes.

On the other hand, eliminating deficiency payments would weaken farmers' incentive to participate in cropland set-aside programs, which have helped to stabilize prices and incomes by removing land from use during times of surplus output.

PHASE OUT TOBACCO AND PEANUT PRICE SUPPORT PROGRAMS (A-350-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	50	50
Outlays	0	0	50	50	50	150

The federal government supports tobacco and peanut prices through the use of acreage allotments and marketing quotas in combination with commodity loans made to farmers. An acreage allotment represents the right to produce and a marketing quota represents the right both to produce and to market. Over time these mechanisms have been used to restrict supply relative to demand to the extent that market prices remained slightly above loan rates. Outlays for these programs are primarily for loans; in 1981, peanut program outlays were about $30 million and the tobacco program showed net receipts from loan repayments of about $50 million.

These programs are, in effect, government-controlled monopolies periodically extended by farmer referendums. The economic benefits of restricted output have been capitalized so that farmers seeking to increase production or obtain entry into the programs must lease or buy the "rights" to produce and market these commodities. Thus these farmers incur substantial costs, while owners of the rights increase their wealth. The costs are ultimately reflected in product prices.

To reduce direct government intervention and eliminate federal outlays, the peanut and tobacco programs could be phased out during fiscal years 1983 and 1984. In place of commodity programs, farmers could be permitted to establish federal marketing orders under federal enabling legislation. This policy would reduce outlays by $150 million during 1985-1987.

Federal marketing orders, issued and supervised by the Secretary of Agriculture, legally obligate first buyers to abide by certain trade practices and restrictions on sales. Marketing orders permit several activities including regulating product flow to market; limiting total quantity to be marketed; prescribing product regulation by size, grade, package, and so forth; providing a means of surplus disposal; checking-off funds for research, promotion, and other activities; and gathering market information. They are not commonly used to restrict production or limit the entry of new farmers. Such actions might be necessary, however, if marketing orders were to provide peanut and tobacco farmers price support similar to that of commodity programs.

Federal marketing orders would entail farmer financing of all costs, except minor federal supervisory expenses. Most likely, funding would come from farmer contributions assessed on each unit of output. While marketing orders would reduce federal intervention and outlays, they would be subject to public scrutiny with respect to their price and supply effects.

ELIMINATE WOOL AND MOHAIR PAYMENT PROGRAM
(A-350-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	43	55	68	74	240
Outlays	43	55	68	74	85	325

The National Wool Act of 1954 authorized payments to farmers on marketings of shorn wool, unshorn lambs, and mohair. Payments are at a rate approximating the difference between the support price established in the law and the national average price received by farmers. The program was enacted as a measure of national security and general economic welfare, because shorn wool was considered an essential and strategic commodity. The objective was to encourage annual domestic production of 300 million pounds of shorn wool.

About $1.3 billion has been paid to farmers since the inception of the program; the amount in 1981 was $36 million. Even so, domestic wool production has declined by more than one-half since 1954 and is now about 100 million pounds a year. The program has clearly not achieved its objectives; it has also been in direct conflict with the reality of declining lamb and mutton consumption and rising use of synthetic fibers. It could be ended without detriment to the nation's supply of food and fiber.

The elimination of program payments would reduce farmers' cash receipts from the marketing of wool and mohair by about a third. Federal payments, however, are only about 10 percent of the total cash receipts that farmers receive from the sale of sheep, lambs, and wool. These payments are made to just 80,000 farmers and average only $400 per farmer. Consequently, the elimination of payments would be of small economic significance to most farmers and would be unlikely to affect measurably the long-term economic viability of the industry.

REDUCE EXTENSION EDUCATION AID TO STATE AND LOCAL GOVERNMENTS (A-350-f)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	57	61	65	69	73	325
Outlays	55	58	62	67	71	313

Extension education activities of state and local governments help people identify and solve their farm, home, and community problems through the use of research findings of the Department of Agriculture and state land-grant colleges. The main costs of the program are for the employment of county agents, home economics agents, 4-H Club agents, state and area specialists, and others who conduct joint educational activities. Federal funds--which account for about 40 percent of overall extension financing--are for the most part allocated to the states by prescribed formula. The federal share in 1981 was about $300 million.

Extension education programs once played an important role in the lives of America's farmers. Today's farm families, however, are far better educated, more fully integrated into the nonfarm economy, and obtain technological information from a wider range of sources. Moreover, the programs no longer focus principally on farm families. Although they still include an emphasis on increasing agricultural efficiency, they are now aimed at improving the quality of life for all citizens.

The level of federal support of extension education activities could be reduced without detriment to the farm economy. A 25 percent reduction in the formula funding to states would save about $313 million over the 1983-1987 period. Total overall extension funding would be reduced by about 7 percent, or, on average, around $1 million annually in each state. The reduction would mean that state, county, and local governments would have to increase their share of extension education costs or cut back on such activities.

TERMINATE FEDERAL FUNDING OF FOREIGN MARKET DEVELOPMENT (A-350-g)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	25	27	29	31	33	145
Outlays	25	27	29	31	33	145

The federal government provides funding support for overseas agricultural market development projects of 50 cooperators (nonprofit commodity groups), 4 regional groups representing 44 state departments of agriculture, and 38 private business firms. Public financing also supports 47 permanently staffed cooperator offices overseas that conduct promotion activities. The federal government spent $20 million in 1980 supporting such foreign market development activities.

Public financing of private overseas market development activities, which began in 1954, was based on the premise that U.S. producer groups needed federal support in penetrating foreign markets. There is no evidence, however, that public financing of private market development activities has been critical to the expansion of agricultural exports. While in some cases exports may have been boosted, it is not clear that the value of the increased sales exceeded the costs to the taxpayer. Moreover, agricultural products often compete with each other for consumers' expenditures, so that public promotion of one product may work to the disadvantage of others. Cooperators tend to rely on federal funds long after they have become established and experienced in foreign market development. Consequently, as new cooperators seek and receive federal assistance, federal outlays increase annually.

If federal funding of overseas market development was discontinued, outlays would be reduced approximately $145 million during 1983-1987. The burden of foreign market development would be shifted to private groups, which could then assess the costs and benefits of their own projects. Government market development specialists could still continue to provide technical assistance, however.

INCREASE THE SHARE OF INCOME THAT TENANTS OF RURAL HOUSING PROJECTS PAY TOWARD THEIR RENT
(A-370-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	8	16	26	37	48	135
Outlays	8	16	26	37	48	135

The federal government, through the Farmers Home Administration (FmHA) Section 515 program, subsidizes the shelter costs of low- and moderate-income households renting housing in rural areas. In 1982, the Section 515 program will assist more than 200,000 households--at a cost exceeding $100 million--by financing developers' mortgages at an annual interest rate of 1 percent. FmHA-aided tenants must pay a minimum of 25 percent of their incomes toward their rent, and in some instances they must pay somewhat more. A change in the 25-percent-of-income rule could reduce federal outlays for the Section 515 program. Specifically, if the income share were raised immediately to 30 percent for new tenants and were raised by one percentage point a year, up to 30 percent, for current tenants, an outlay savings of about $135 million could be realized over the 1983-1987 period.

Proponents of this change could view it as equitable, since, in accordance with the reconciliation act of 1981, tenants assisted by the U.S. Department of Housing and Urban Development will be required to pay 30 percent of annual income toward rent by 1986. Critics would argue, however, that the change could create excessive hardship for FmHA-assisted families. Although residency in FmHA housing is restricted to households with incomes below maximums ranging from $17,000 to $23,500, adjusted to reflect prevailing housing costs and household expenses, most tenants actually have incomes considerably below those maximums.

DISCONTINUE DIRECT POSTAL SERVICE SUBSIDIES (A-370-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	789	740	804	822	740	3,895
Outlays	789	740	804	822	740	3,895

Under the designation "public service", the U.S. Postal Service (USPS) has used funds appropriated from the U.S. Treasury to subsidize certain operations that are not cost effective, such as postal facilities in remote areas and Saturday mail delivery. Also with Treasury funds, the USPS has subsidized postage for handicapped persons, religious and other not-for-profit organizations, and certain other mailers, including small newspapers; these latter subsidies are termed "revenue forgone." In the 1981 reconciliation act, the Congress cut these subsidies substantially through 1984. Accordingly, the public service subsidy will be phased out, and the revenue forgone payment will be cut by about 12 percent. If, instead, the subsidies were eliminated entirely as of 1983 (except for the subsidy for handicapped mailers, which is estimated to cost $17 million in 1982), the savings through 1987 would amount to $3.9 billion--$0.1 billion from public service provisions and $3.8 billion from revenue forgone.

Eliminating the public service subsidy in 1983 instead of 1984 would necessitate accelerating service reductions, rate increases, or some combination of both. A general postage rate increase of less than 0.5 percent could effectively offset the lost subsidy. Termination of the revenue forgone subsidy--now projected to cost $597 million in 1982--would specifically affect the beneficiaries of this provision, who would lose the privilege of mailing at reduced rates and would have to pay full rates instead. Postage costs for such parties could nearly double during 1[illegible]. These increases would be compounded on top of the rate increase that occurred in January 1982 in response to cuts enacted by the reconciliation legislation. (The January increases for typical subsidized mailings ranged from 4 percent to 105 percent.)

The justification advanced for preferential postage rates is that they promote the flow of news and educational, cultural, and charitable materials. With regard to small newspapers, critics argue that the true effect is to subsidize publishers' and advertisers' profits. With regard to not-for-profit organizations--the largest users of reduced rates--critics maintain that the subsidy is poorly targeted, resulting in overuse of mail solicitations, and increases the volume of "junk" mail. Moreover, critics argue that the impact of rate increases on not-for-profit organizations as a group would be small, pointing out that the subsidy may represent less than an estimated 0.2 percent of that group's reported income (based on 1978 data and not including religious groups).

ELIMINATE SMALL BUSINESS ADMINISTRATION BUSINESS LOANS AND PROGRAMS
(A-370-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	260	335	540	675	730	2,540
Outlays	250	320	505	625	675	2,375

The federal government, through the Small Business Administration (SBA), makes direct loans to small businesses that are unable to obtain credit in the private market. The SBA has the authority to make $225 million in new direct loans during fiscal year 1982. If current policy is continued, new SBA loans are projected to total some $230 million in 1983. The actual federal costs of SBA loans are not reflected by the year's budget outlays for loan disbursements, however. Defaults on previous loans and administrative expenses account for the actual costs. For example, the SBA estimates that it will write off about $180 million in fiscal year 1982 for defaults on outstanding direct loans. Thus, of the $225 million in new direct SBA loans issued in fiscal year 1982, an estimated $25 million or more will be lost to SBA over several years as a result of insufficient repayments of principal and interest by loan recipients.

In addition, the SBA guarantees private loans to enterprises not deemed creditworthy by the private credit market. Under CBO's baseline projections, the SBA will have the authority to guarantee $3.0 billion in loans during 1983. This $3.0 billion will have no immediate effect on federal budget outlays, but instead will be reflected in future outlays to cover borrowers' defaults. Default payments for outstanding SBA-guaranteed loans totaled $472 million in fiscal year 1981--appreciably more than the $316 million in direct new loans the SBA issued that year.

Terminating the SBA loan program could yield significant outlay reductions. First, abolishing the direct loans would achieve outlay savings of about $788 million during the 1983-1987 period. Second, if no further loans were guaranteed from 1983 through 1987, outlays for defaults on guaranteed loans would be reduced by about

$1.4 billion. Moreover, additional five-year savings of $180 million could be realized through reduced administrative costs. Together, these actions would produce a total outlay savings of nearly $2.4 billion for the five-year period.

Critics of this proposal see it as having a negative effect on the economy, in that the investment and employment generated by profitable SBA-aided firms would be lost. The Congress targets a substantial amount of SBA lending to groups that traditionally have had difficulty in obtaining loans because of the nature or location of their businesses (notably, energy development, venture firms, and economically deprived areas) or because applicants lack track records (for instance, high-risk entrepreneurs, and minority and handicapped persons).

REDUCE FUNDING FOR AMTRAK
(A-400-a)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	255	279	323	350	372	1,579
Outlays	222	237	315	342	363	1,479

Amtrak operates passenger trains in the Northeast Corridor and on 37 other intercity routes serving a total of 45 states. The system carries less than 1 percent of intercity passenger traffic, however. Ridership has changed little since 1977, rising on average about 1 percent a year. In the same period, operating losses have risen 49 percent (nearly 10 percent in real terms), from $483 million in 1977 to $720 million in 1981. Fares and other nonfederal revenues covered only 42 percent of Amtrak's operating costs in 1981; federal appropriations covered the remainder. When allocated by route, the federal subsidy ranges from $12 per passenger on Northeast Corridor routes to more than $100 per passenger on several long-distance routes. Besides passenger subsidies, the federal government also provides all of Amtrak's capital funding--$177 million in 1981--and it has provided $2 billion for track and other improvements in the Northeast Corridor. Amtrak's operating costs and deficits have increased dramatically every year.

Amtrak's losses, and thus its federal subsidy, can be reduced substantially only by cutting routes. If the Amtrak system were limited to routes on which ridership is strongest and for which the prospects for improved ridership and better financial performance are greatest--in the Northeast Corridor, along part of the West Coast, and on certain routes around Chicago--the federal subsidy could come down by $1.5 billion over the 1983-1987 period. Limiting the system this drastically would maximize Amtrak's financial prospects, while shifting less than one-half of one percent of intercity passenger traffic to other modes. Additional federal savings could be gained by instituting new cost-sharing arrangements with state and local governments for the commuter-type service that Amtrak now operates in some areas, and by altering Amtrak's labor protection agreements to reduce the benefits available for displaced employees.

Three main arguments have been cited for reducing Amtrak's subsidy. First, the federal subsidy--roughly 23 cents per passenger mile in fiscal year 1980, or $50 per passenger, system-wide--already far exceeds the subsidies provided to other modes of transportation. Commercial aviation receives less than 1 cent per passenger mile in federal subsidies. The intercity bus industry, a more direct competitor with Amtrak in most areas, receives even less--approximately one-tenth of a cent per passenger mile. Results from ongoing Department of Transportation studies suggest that auto travelers pay their full federal costs through fuel and other user taxes.

Second, most Amtrak routes hold little or no promise for either significantly increased patronage or reduced costs, thus presenting continually increasing requirements for federal subsidies. Although ridership on some routes has surged during gasoline shortages, it has subsided quickly thereafter.

Third, little evidence supports arguments that the return on the federal investment in Amtrak, expressed in such terms as energy savings or transportation services to low-income persons, justifies the cost. Amtrak could save energy for the nation only if all service outside the Northeast Corridor were halted. Similarly, equity considerations are of little concern in reducing Amtrak's subsidies, because Amtrak does not carry a disproportionately high percentage of low-income passengers; buses serve far more low-income persons.

Arguments for maintaining the current Amtrak system include the fact that it provides reliable transportation to many areas that have no air service and where bus service is often subject to weather interruptions. Amtrak can play an important--albeit small --role in moving people during transportation emergencies arising from such events as acute oil shortages and labor strikes against other modes. Some of Amtrak's supporters also argue that ridership will increase substantially now that new equipment is operating and service has improved.

END MASS TRANSIT OPERATING SUBSIDIES
(A-400-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	1,140	1,220	1,300	1,380	1,460	6,500
Outlays	1,030	1,210	1,290	1,370	1,450	6,350

The federal government provides operating assistance for virtually every local public transit system in the country, on average covering about 15 percent of operating costs. This aid, which began in 1975, will exceed $1 billion in 1982. If mass transit operating aid were withdrawn, savings in the next five years would total about $6.35 billion.

Three-fourths of the present operating aid is allocated by a formula that favors small and medium-sized cities; thus the federal subsidy per rider in these cities is disproportionately greater. These same recipient areas will therefore face more drastic fare increases or service cutbacks if the aid is ended. In absolute dollars, however, the largest urban areas would lose the most: New York, $193 million; Los Angeles, $84 million; Chicago, $74 million; Philadelphia, $47 million; Detroit, $32 million; San Francisco, $29 million; Boston, $26 million; and Washington, D.C., $25 million.

The main argument for ending these subsidies is that there is no rationale for imposing on national taxpayers the costs of operating local transit. The fare structures and benefits of these systems are the products of local decisions. Furthermore, federal aid may encourage inefficient operations, because it comes with statutory requirements that may inhibit innovation. For example, one provision now in effect requires that the aid not imperil the jobs of current workers, a constraint that may discourage innovative management techniques and efficiency measures.

Supporters of transit operating aid argue that state and local governments would have difficulty replacing these funds, and many systems would have to cut services or raise fares. The difficulty stems in part from the widespread practice of holding fare increases below cost increases. On average, today's transit rider pays about 45 percent of the operating costs; ten years ago, the riders' share was 80 percent. As a result, transit operators have been facing increasingly severe financial problems, even with federal aid. For example, in July 1981, Chicago increased its basic bus and subway fare by 10 cents to 90 cents, with a further increase of 10 cents budgeted for April 1982. If federal aid is eliminated for 1983, another 20 cents would be required.

Fare increases are almost certain to drive away transit riders--perhaps a 2 percent loss for every 10 percent increase in fares. Such an increase could pose special problems for low-income riders, few of whom have any alternate means of transport. Targeted aid might be a more effective way of helping those in need than subsidizing all riders, rich and poor alike.

REDUCE FEDERAL SHARE FOR MASS TRANSIT CAPITAL GRANTS (A-400-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	1,090	1,170	1,260	1,350	1,440	6,310
Outlays	120	290	560	820	1,110	2,900

For 1982, $2.5 billion in federal mass transit capital grants have been appropriated, including some $540 million available for transit in exchange for road segments withdrawn from the Interstate Highway System. This represents a cut of $660 million from 1981.

Only in the last decade has the federal government assumed a major role in financing local mass transit. At present, though, the federal government provides 80 percent of the cost of capital projects, with state and local governments covering the remainder. A change in this ratio to a 50-50 federal-state match would encourage state and local governments to apply more stringent economic criteria to mass transit investments. As a result, many projects would be greatly reduced in scale and complexity--or even eliminated--and federal spending for mass transit cut by 40 percent, saving $2.9 billion in outlays over the next five years. These funds would likely be replaced through some combination of increased state and local funding, decreased service, and increased fares. Some additional help would be provided through creative use of the 1981 tax law changes that permit tax-exempt public transit agencies to sell tax benefits to private firms; because of the revenue loss involved, however, this would offset some of the outlay savings.

Another option would be to end federal capital grants altogether, saving about $7 billion in outlays over the next five years. Although this change would force substantial readjustment, there is growing evidence that, in some situations, transit service can be provided more efficiently without federal aid and its attendant restrictions. For example, a number of suburban areas (Montgomery County in Maryland and parts of the San Diego suburbs in California are examples) are served more cheaply by bus operators, which receive no federal capital or operating aid. Savings are achieved by using lower-cost (largely nonunion) labor and by more effective use of capital--possibly smaller or older buses. Dramatic savings have already been achieved in some areas where local governments have had to cover all their mass transit capital expenses. San Diego, for example, recently completed an 18-mile light rail system in record time and for only $5 million a mile--about one-tenth the cost of similar systems sponsored by the federal government.

Ending capital grants, particularly if done on short notice, would be a severe measure. Some small and medium-sized cities that are not dependent on public transit would surely end their service. Larger cities would be forced to make dramatic reassessments of how they now provide transit services. Even if these changes--greater use of contracting out to the private sector, for example--resulted in more efficient transit services in the long run, the burdens of the transition would be difficult in the short term.

REFOCUS THE FEDERAL HIGHWAY PROGRAM
(A-400-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	4,730	4,900	5,120	5,330	5,570	25,650
Outlays	330	1,850	3,500	4,250	4,400	14,330

Federal and state governments have shared responsibility for financing construction of highways since 1916. Over the years, this partnership has grown to include more and more segments of the nation's road network. Federal participation now extends to the National System of Interstate and Defense Highways (at a cost of $3.1 billion in 1982); primary state roads (at $1.5 billion); secondary and urban roads (at $1.2 billion); bridge replacement (at $0.9 billion); and safety and miscellaneous other projects, such as bicycle paths and overseas highways. The federal government will spend $8.3 billion on roads in 1982, and this sum will grow to $11 billion by 1987 if current policies are continued.

Over the next five years, some $14 billion in outlays could be saved by gradually limiting the federal highway program to its original emphasis on intercity arteries and the bridges they include. The largest savings would come from redefining the interstate system to include only projects that serve interstate commercial and passenger travel. At present, local routes and design modifications serving societal and environmental objectives cost more than half of the $39 billion (in 1979 dollars) needed to complete the federally aided interstate plan. Returning financial responsibility for urban and secondary roads to state governments would account for $5 billion of the projected $14 billion in outlay savings over the next five years.

Alternatively, limiting federal highway construction funding to projects of interstate importance could permit the federal government to finance more of the maintenance costs of the growing interstate highway system. For example, the Administration has proposed some of the actions outlined above, along with an expanded interstate highway maintenance program that would be financed dollar for dollar from reductions in federal highway programs other than the interstate highway program. If this proposal were adopted, net budget savings would be smaller.

By withdrawing support from urban and local routes, the federal government would force substantially greater state and local expenditures for such roads, and many projects would be deferred or abandoned altogether. Cutting out urban interstate routes at this stage would break federal commitments made as long ago as 25 years. For this reason, legislative proposals to eliminate parts of the interstate system usually include some compensating increases for other activities, thereby diminishing the budgetary savings.

SHIFT AIRWAYS OPERATING COSTS TO THE AIRPORT AND AIRWAYS TRUST FUND
(A-400-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	0	0
Outlays	0	0	0	0	0	0

The Airport and Airways Revenue Act of 1970 established the Airport and Airways Trust Fund, financed by user taxes on aviation fuel and passenger tickets. The Congress traditionally has restricted the use of these tax revenues to airport capital improvements and to cover part of the airways system's operating costs. Total costs in 1981 were $3.3 billion, of which $1.4 billion came from the trust fund and $1.9 billion from general revenues.

Because of the restricted use, receipts from aviation user fees have built up in the trust fund, accumulating a surplus of approximately $3 billion. Transferring all airways system operating costs to the trust fund would reduce the drain on general revenues by about $6.7 billion over the next five years, but the reduction would be offset by increased spending from the trust fund. There would be no effect on the federal deficit unless, for example, aviation user fees were increased to cover the associated costs now paid from general revenues (as described in B-400-a).

Restrictions on the purposes for which user fees can be spent stem from the view that general taxpayers benefit from the military and other "common-good" applications of the airways system, making it fair for general taxpayers to cover at least part of the system's costs. This argument is inconsistent with the operation of other federal trust funds, however. The highway trust fund is financed fully by highway users, despite any indirect defense or other benefits that nonusers might receive. Making the direct recipients of air services responsible for all related costs would encourage more efficient use of the aviation system. Some projects to expand airports or other aviation facilities might, in turn, be deferred or abandoned, offering the potential for additional savings.

END GRANTS-IN-AID FOR LARGE AIRPORTS
(A-400-f)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	180	200	220	230	240	1,070
Outlays	40	130	180	220	230	800

The Airport and Airways Development Act of 1970 authorizes the Secretary of Transportation to make grants-in-aid for airport development through the Airport and Airways Trust Fund. In 1981, $450 million in grants went for capital improvements at 581 of the nation's airports.

The Congress could terminate federal grants for capital improvements at large and medium-sized central airports. Such airports are already close to financial self-sufficiency, and replacement of federal grants by local user charges should be possible. A reduction in grant support for large and medium-sized hub airports was approved by the Senate in 1980, and President Reagan made similar proposals in his 1982 budget recommendations. If grants to large airports were eliminated, the five-year outlay savings would be about $800 million.

Large airports usually finance most of their investments from landing charges, rental fees, and other local sources, and federal grants are spread so thin among larger airports that they are not critical in financing major capital improvements. In Atlanta, for example, federal construction grants account for only 2 percent of the airport's capital program. The rest is financed from local revenues from various sources.

Opponents of withdrawing federal grants to large airports question the inequity of subsidizing general aviation and small community airports with revenues paid by large airport users into the Airport and Airways Trust Fund. Advocates of this position note that general aviation users now cover only a small fraction of the airport and airways costs they incur, and that small community air subsidies are already in effect.

Proponents of plan ending federal financial support to large airports argue that restricting federal aid to small (reliever) and general aviation airports represents a more cost-effective use of trust fund revenues, helping to target federal resources to those facilities where local support and user financing are most problematic. In addition, it is argued that large airports would still benefit, inasmuch as the additional investment in smaller airports would help draw general aviation users to them, thus helping to lighten traffic through the nation's larger airport facilities.

ELIMINATE MARITIME INDUSTRY SUBSIDIES
(A-400-g)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	96	128	163	201	241	829
Outlays	30	69	120	176	221	616

The Maritime Administration, a unit of the U.S. Department of Transportation, assists the U.S. maritime industry through construction subsidies to shipbuilders and operating subsidies to shipowners. No new budget authority for construction subsidies was authorized for 1982, but unobligated budget authority carried over from previous years totals about $70 million. Funding for maritime operating subsidies runs at about $400 million annually.

These subsidy programs are intended to put U.S. shipyards and shipping companies on a footing that is competitive with foreign counterparts. Foreign shipyards can now build ships for about half of U.S. costs. Similarly, foreign carriers operate for about two-thirds the costs of U.S. ships. Maritime Administration subsidies narrow these differentials so that the U.S. maritime industry can meet this foreign competition.

Terminating these two subsidy programs would result in total five-year outlay savings of about $616 million--$391 million from reduced operating subsidies and $225 million from reductions in construction outlays (assuming that new budget authority for construction subsidies would otherwise be provided in 1983 and thereafter). The estimated savings fall short of the costs of current programs, because construction obligations spend out over a period of years and operating subsidies are contractual obligations with shippers, typically for periods of 20 years. Thus, phasing the operating subsidy program out entirely to capture the full savings would take about 20 years. In the meantime, however, some additional savings--not accounted for in the CBO estimate--could be realized under current contracts, since the exact level of federal support is usually unspecified. For example, the government might reduce the number of sailings subsidized under a given contract.

One argument in favor of eliminating these programs is that federal subsidies support only a small share of U.S. maritime activities. For example, only two to six ships a year, at most, are built under federal subsidy--a quite small share of the current national production volume of roughly 50 ships a year. The construction subsidies therefore have a limited effect on U.S. shipbuilding capacity. Supporters of the subsidies point out that, if the two subsidies were ended, some loss in shipbuilding capacity, some adverse effects on U.S. export and import prices, and some loss of employment would probably result.

REDUCE FUNDING FOR THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM (A-450-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	922	992	1,062	1,128	1,190	5,294
Outlays	92	376	773	1,013	1,080	3,334

The Community Development Block Grant (CDBG) program funds a wide range of urban development and social service activities. Since its creation in 1974, the program has received more than $26 billion in appropriations, including $3.5 billion in 1982. Nearly three-fourths of the funds are distributed on an entitlement basis to central cities of metropolitan areas and to other cities with populations over 50,000. The remainder of the CDBG funds is distributed on a discretionary basis by the Secretary of the U.S. Department of Housing and Urban Development (HUD), mostly to small cities. Most CDBG recipient communities use their grants for repair or replacement of such public works as streets and sidewalks, water lines and sewers, and for housing rehabilitation.

CDBG funds have been dispersed fairly widely. In 1981, 669 cities and urban counties were entitled to grants, and roughly 2,000 small cities received competitively awarded grants. Although the entitlement formulas weight the funding allocations toward older, more distressed areas, the program aids many jurisdictions that are in relatively good fiscal condition. For example, 15 of the least-distressed entitlement cities--including Jacksonville, Houston, Phoenix, and San Diego--received from $12 to $20 per capita in 1981. [1] The range for 15 of the most distressed entitlement cities--including Newark, Cleveland, Chicago, and Oakland--was $35 to $66 per capita.

CDBG funding could be reduced by one-fourth on the ground that budgetary restraint requires curtailing federal assistance for activities that relatively healthy cities could undertake on their own. This would save a total of about $3.3 billion over the 1983-1987 period. To maintain current-level funding for more distressed areas, the Congress could develop eligibility criteria to limit grants to those jurisdictions with relatively high levels of need.

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[1] Cities ranked according to distress measures developed by HUD in City Need and Community Development Funding (January 1979).

Arguments against reducing CDBG funding and narrowing its targeting include the fact that the program is one of the largest remaining sources of fiscal assistance for many cities. Funding from such sources as the Urban Mass Transportation Administration and the Environmental Protection Agency has been cut drastically; this may argue for a more gradual reduction in CDBG funding--if any--to allow localities to adjust for the loss of other federal revenue. Also, CDBG provides a great amount of funding for such activities as housing rehabilitation and infrastructure repair--work that many cities have not been able to fund out of their own resources. Finally, many of the more healthy cities undoubtedly use CDBG funds to improve impoverished neighborhoods that might be neglected in the absence of federal aid.

REDUCE FUNDING FOR LOCAL ECONOMIC DEVELOPMENT (A-450-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	216	233	250	266	281	1,246
Outlays	14	71	136	219	247	687

The federal government tries to stimulate private investment and employment in distressed areas by funding public works projects and by making credit available to private firms. The Urban Development Action Grant (UDAG) program of the Department of Housing and Urban Development (HUD) extends grants to local governments that use the funds to build public works and to provide credit and other assistance to private firms. The Economic Development Administration (EDA) offers public works grants to communities, loans funds directly to private firms, and guarantees privately placed loans. The Farmers Home Administration (FmHA) guarantees private business loans. In 1981, the federal government provided a total of $1.0 billion in economic development funds through these programs--$923 million in grants and $111 million in direct loans. In addition, it provided $904 million in loan guarantees.

The effectiveness of these programs depends on the federal government's ability both to direct funds to areas with serious economic and social problems and to assist only those endeavors that could not otherwise be funded. A large portion of federal economic development assistance is offered to areas that are not generally considered distressed. A portion of the funding from each of the several programs supports firms or projects that would probably proceed without federal financing.

By cutting and adjusting the current programs to correct these problems, federal assistance for local economic development could be reduced substantially while continuing to aid the most distressed areas. The grant and direct loan programs of the EDA and HUD could be reduced by one-third--yielding $687 million in budget savings over the 1983-1987 period--and these agencies' targeting requirements could be made more restrictive. Although they already target their funds, the EDA and HUD still assist some communities that are in good economic health, and they often fund projects in vital commercial centers of some otherwise distressed cities, where full conventional financing might soon become available. The two agencies also provide some funds to firms that could receive private credit and to public works projects that could be funded locally.

Federal loan guarantee programs could also be reduced--by some $2.1 billion over the 1983-1987 period. (This would not, however, be reflected in budget savings). EDA's guarantee authority could be reduced by one-third, while FmHA assistance could be terminated. The same arguments that apply to grant and loan programs also apply to loan guarantees. FmHA focuses most of its assistance on localities that, by most measures, are not economically distressed. This agency also generally funds less risky projects than the EDA or HUD and uses nearly 30 percent of its guarantee authority for debt restructuring and the transfer of ownership--activities that may not necessarily be linked to new investment. FmHA assistance may thus be more prone than EDA or UDAG aid to substitute for private credit, and it may also yield less in the way of new investment and employment.

An argument against eliminating FmHA business support while only reducing program levels in the other cases is that the reductions would hit rural areas more heavily than urban ones. FmHA focuses its guarantees on areas with populations of fewer than 25,000, while the EDA and HUD focus more strongly on urban areas. Since both agencies direct a large proportion of their funds to distressed areas, reducing these programs' funding might delay or cancel some projects, with consequent erosion of local tax bases and loss of employment prospects.

REDUCE FUNDING FOR ELEMENTARY AND SECONDARY EDUCATION BLOCK GRANT
(A-500-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	100	110	120	130	135	595
Outlays	10	80	110	120	125	445

The 1981 reconciliation act consolidated more than 20 smaller education programs into a single block grant to state education agencies. The Continuing Appropriations Resolution set fiscal year 1982 funding for the new grants at $470.4 million--17 percent below the level needed to maintain the prior year's level of services under the previous categorical programs, after accounting for inflation.

An additional 20 percent reduction in funding for this program would save more than $400 million over the next five years. In its present form, the block grant largely allocates funds to states in proportion to their total school-age populations, and the funds may be used for any of the purposes of the previous categorical programs, which included programs as diverse as basic skills improvement, metric education, programs for the gifted and talented, and the ethnic heritage program. Since the new block grant is not targeted on any specific group of students and is only loosely targeted at any specific services, reducing funding for the block grant, in lieu of like cuts in the targeted categorical programs remaining, would minimally disrupt support of those students and services that may be of greatest concern to the federal government.

The principal argument against reducing the block grant funding is that the Congress, in consolidating the programs, reiterated its commitment to the basic goals of the predecessor programs. Those who favor reduced funding, on the other hand, might hold that the block grant is not effectively targeted at those goals, since funds are allocated on the basis of school-age population rather than on the basis of any criterion related to the goals of the predecessor programs, and also because federal oversight and control under the block grants are likely to be minimal.

REDUCED FUNDING FOR VOCATIONAL EDUCATION
(A-500-b)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	350	370	400	425	460	2,005
Outlays	30	275	365	390	420	1,480

The federal government contributes to state vocational education programs under the Vocational Education Act (VEA) of 1963. The 1982 federal contribution is $646 million, down from $674 million in 1981. About 50 percent of federal VEA funding is unrestricted, so that states and localities may use it to support general vocational education programs. The remaining funds are targeted by the Congress on certain disadvantaged population groups or are restricted to certain activities, such as bilingual education and program improvement efforts.

Eliminating the untargeted portion of Vocational Education Basic Grants beginning in 1983 would result in cumulative savings of about $1.5 billion in 1983-1987. Savings in the initial year would be small, however, because the program is forward-funded.

Those who favor such a reduction argue that the federal contribution is not essential to the continuation of general vocational education programs; that the principal beneficiaries of these programs are youths who are generally not disadvantaged; and that the job-specific skill training that is the mainstay of general vocational education programs has not been shown to be of particular benefit, especially at the high school level where most VEA funds are spent.

Those who oppose eliminating untargeted support argue that the states and school districts may in some cases not pick up the slack, thereby lessening access to vocational education for some students. This would be a loss principally at the postsecondary level, where vocational training appears to yield long-term benefits. Pell grants, however, are available to persons who wish to enroll in vocational education or other programs at the postsecondary level.

Another option would be to fold all federal vocational education support into the general elementary and secondary education block grant described in the previous item. The savings achieved would depend on the level of overall funding provided by the Congress for the block grant. This option would, however, probably reduce the targeting of federal education dollars on specific disadvantaged populations and on specific program goals.

RESTRUCTURE CAMPUS-BASED STUDENT AID PROGRAMS AND REDUCE THEIR FUNDING
(A-500-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	265	275	300	320	340	1,500
Outlays	40	225	280	300	340	1,165

Three federal student assistance programs are administered directly at the campus level--College Work Study (CWS), National Direct Student Loans (NDSLs), and Supplemental Educational Opportunity Grants (SEOGs). Appropriations for these campus-based programs in 1982 total approximately $1 billion--50 percent for part-time work, 20 percent for loans, and 30 percent for grants. In addition to providing different types of aid, the three programs differ in their rules for distributing funds to institutions, the rates at which institutions are required to match federal funds, and the degree to which funds are targeted on low-income students. Current rules allow institutions to shift some of their allocations among the programs to reflect different institutional priorities and needs.

One means of curtailing campus-based aid would be to combine the current programs into a block grant and reduce funding by 25 percent. This would save $40 million in 1983 and about $1.2 billion over the 1983-1987 period. The same savings could be achieved by retaining the separate programs and simply cutting their funding; this course, however, unlike a block grant, would not enlarge institutional discretion on how best to allocate funds among types of aid and types of students.

On the other hand, combining the campus-based programs while reducing funding would clearly make less student aid available. Because institutions are already allowed to switch some funds among campus-based programs, a block grant might not substantially increase their discretion. Providing the funds as a block grant could also decrease targeting on more needy students if the emphasis was switched among programs.

ELIMINATE FEDERAL IN-SCHOOL INTEREST PAYMENTS FOR GRADUATE STUDENTS
(A-500-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	-25	100	220	300	355	950
Outlays	-15	65	190	280	340	860

Obligations for the Guaranteed Student Loan (GSL) program rose very rapidly, from $700 million in 1978 to $2.9 billion in 1981, after the Congress made all borrowers eligible to have the interest on their loans paid by the government while they were in school. Under the 1981 reconciliation act, all GSL borrowers remain eligible for the in-school interest subsidy, but only those from families with incomes under $30,000, or who can demonstrate actual financial need, may now obtain such loans. The act also added a requirement that borrowers pay an origination fee equal to 5 percent of the amount borrowed. For all new GSL borrowers, the government pays 9 percent interest on their behalf while they are in school. It also pays the lender a variable amount, currently 7 percent, for the life of the loan. This payment provides the lender a market rate of return.

Practically all graduate students continue to qualify for GSLs, and it is estimated that nearly 600,000 of approximately 1.4 million such students will obtain GSLs in 1983. If their eligibility for the in-school interest subsidy were ended, but they remained eligible for GSLs and were relieved of the origination fee requirement, the 1983-1987 savings would be about $860 million. This option assumes that graduate GSL borrowers could also borrow the anticipated in-school interest at the time their loans were made. The lender would thus be assured a yield equal to that now obtainable, but the borrower would make no actual payments until leaving school; other formulations are possible.

The argument for such a change is that even a 9 percent loan is highly subsidized and that the further subsidy represented by the government's payment of in-school interest charges is not necessary in the case of graduate students. They would pay the interest in the form of somewhat higher repayments after leaving school, but they would have better income prospects than other students. If any had difficulty making repayments, the loan could be renegotiated in the light of actual ability to pay.

Opponents of such a change might point to the high real burden of meeting educational costs and argue that this option would increase the large debt burdens some students face on leaving school. Some present lenders might drop out of the program because of its increased complexity, making GSLs harder to obtain. Opponents also assert that, since the Congress has legislated changes in the GSL program in each of the last four years, there should now be a pause so the actual impact of current law can be assessed.

This option increases costs during the first year of implementation for two reasons. First, the entire increase in federal costs from the elimination of the origination fee for graduate students is felt when loans are made, whereas the reduction in costs attending the elimination of the federal payment of in-school interest is felt for only that portion of the year after the loans are made. Second, many graduate students increase their borrowing to cover the in-school interest so that total loan volume increases and federal payments to lenders also increase.

REQUIRE STATES TO PUT UP MATCHING FUNDS FOR CETA TRAINING PROGRAMS
(A-500-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	175	185	200	215	230	1,005
Outlays	170	180	195	210	220	975

If current policy is continued, state and local governments will receive $1.9 billion in 1983 to support training programs for economically disadvantaged persons funded under Title II-B and C of the Comprehensive Employment and Training Act (CETA). Savings would result if states or localities were required to put up matching amounts in order to obtain the federal funds. This option could also be shaped to target CETA funds on areas with the least capacity to pay or the most severe unemployment problems.

The option discussed here, which would require states to match according to their ability to pay, would save approximately $170 million in 1983 and about $1 billion during 1983-1987. The least well-off one-third of the states would not have to provide matching funds. The best-off states would have to provide $1 to obtain $4 of federal funds, whereas the middle group would be required to provide $1 to get $9. This estimate assumes that all states would participate. To the extent that they did not, federal savings would increase while the total number of economically disadvantaged persons enrolled in training programs would decline.

Opponents of this proposal would point to the already strained fiscal circumstances in many areas, and to the difficulty of establishing a fair formula for determining state or local fiscal capacity and hence the level of the required match.

CAP MEDICAID EXPENDITURES FOR LONG-TERM CARE (A-550-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	200	550	900	950	1,050	3,650
Outlays	120	440	890	930	1,020	3,400

Federal Medicaid expenditures for long-term care rose from $2.0 billion in 1974 to $5.7 billion in 1980, an average yearly increase of 19 percent, much higher than the average increase of 13 percent for all other Medicaid expenditures. Expenditures for long-term care (consisting primarily of nursing home care) account for 44 percent of Medicaid expenditures.

If annual increases in federal Medicaid spending in 1983 and beyond for these services were limited to increases in medical care prices with an additional allowance for growth in the elderly population after 1984, savings during 1983-1987 would total about $3.4 billion. (The savings estimate assumes that through 1984 federal funds for acute care services would continue to be reduced for those states experiencing annual increases in excess of target levels.) To adapt to reduced funding for long-term care services, states could be given broader discretion to substitute the provision of social services and other assistance that would enable recipients to remain in their own homes. The 1981 reconciliation act has already made it possible for states to seek federal approval to provide homemaker services, social services, adult day care, and other services to the nursing home population under the Medicaid program. Several studies have demonstrated that home care can be provided at less cost than nursing home care to some persons who would otherwise be institutionalized.

Adding a cap on long-term care expenditures to the limitations contained in the reconciliation act would further restrain increases in outlays for this fast-growing component of the Medicaid program, giving states an even greater incentive to substitute home health care and other less expensive noninstitutional alternatives.

Opponents of a cap on long-term care argue that states might be able to achieve only limited savings if the portion of nursing home residents that could be efficiently cared for outside these facilities was small, or if the result was to increase greatly the number of persons receiving Medicaid long-term care by providing a broader range of noninstitutional services. Finally, the proposal would be uneven in its impact on the states. Application of a ceiling on long-term care would penalize states that have already successfully limited growth of these costs, because they would have less latitude to reduce expenditures for nursing home care.

ALTER THE PATTERN OF HOSPITAL COINSURANCE CHARGES UNDER MEDICARE
(A-550-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	-180	-315	-455	-610	-780	-2,340
Outlays	1,100	1,250	1,450	1,650	1,900	7,350

Under the Medicare Hospital Insurance (Part A) program, patients pay a deductible equal to the estimated average cost of one day's hospitalization--$260 in 1982 and about $300 by 1983. They also pay coinsurance charges (generally 25 percent), but only after 60 days of hospitalization for a particular spell of illness. Consequently, very few Medicare patients--about 0.2 percent--pay hospital coinsurance in any year.

In addition to the first-day deductible, beneficiaries could be required to pay 10 percent of the cost of the deductible for the next 30 days of a hospital stay in each calendar year--about $30 per day in 1983. Medicare would cover all charges in excess of any stay beyond 31 days, or of separate stays above 31 days in a year, thus improving coverage for participants with unusual hospitalization needs. Enrollees would pay only one $300 deductible, no matter how many times hospitalized in a year. This option implicitly sets a maximum yearly out-of-pocket individual liability for hospital costs of about $1,200 for 1983. The Medicaid program would continue to pay the coinsurance costs for those elderly and disabled persons enrolled in both programs. Enactment of this proposal would save about $7 billion over the next five years.

Coinsurance provisions can help to limit federal expenditures in two ways. These provisions make the patients responsible for part of the costs, directly reducing required federal outlays. In addition, hospital patients who pay part of the cost of their care are likely to become increasingly concerned about holding down medical expenditures, limiting their admissions and lengths of stay. Persons with private supplemental insurance, however, would have less incentive to hold down the cost of care if this new coinsurance was covered.

On the other hand, out-of-pocket costs would rise substantially for the majority of elderly and disabled who are hospitalized. Only a small number of Medicare participants would benefit from the improved catastrophic coverage in any one year, whereas the potential $1,200 in cost-sharing represents about 15 percent of average per capita income for the elderly. In addition, since physicians' fees are currently subject to coinsurance under Part B of Medicare, the burden of an illness requiring hospitalization could rise to well over $1,200. Moreover, persons ineligible for Medicaid who could not afford the cost-sharing might forgo some needed medical care.

Although this option would make patients sensitive to the quantity of medical care used, it would not directly encourage use of lower-cost facilities. A different option could be designed to give patients incentives to use less expensive hospitals. Medicare hospital benefits for days 2 through 31 could be based on average per diem costs in hospitals in an area. Patients would be liable for the difference between that amount and the hospital's allowable cost. Patients in low-cost hospitals would therefore pay less than those in hospitals with higher than average costs.

EXPAND MEDICARE HOSPITAL REIMBURSEMENT LIMITS TO INCLUDE ANCILLARY SERVICES

(A-550-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	-10	-45	-110	-215	-340	-720
Outlays	250	550	975	1,500	1,700	4,975

Medicare limits reimbursement for routine hospital services (room and board, including nursing) to 108 percent of mean per diem costs in groups of similar hospitals. Reimbursements for ancillary services (such as lab tests and X-rays), which account for much of the recent growth in the cost of hospital stays, are not included under these limits, however.

If both routine and ancillary services were subject to an upper limit, large savings could be obtained. The nearly $5 billion five year savings figure shown above assumes a reimbursement ceiling of 110 percent of the group mean, adjusted for diagnostic mix, and a hold-harmless provision to prevent individual hospitals in the early years from receiving less reimbursement than they had in previous years.

Reimbursement ceilings give relatively high-cost hospitals an incentive to reduce costs. The potential for reductions is greater for ancillary services than routine services. Hospitals would have incentives to encourage physicians to reduce use of diagnostic services and treatments when they have limited medical value. In addition, extending the reimbursement limits would remove the current incentive for hospitals to shift costs to ancillary services to avoid the ceiling on routine costs.

This proposal has several drawbacks, however. First, it could lower the quality of care. Second, some of the reduction in reimbursement would be made up by higher charges to non-Medicare patients.

Finally, because variation in the use of ancillary services is particularly sensitive to the types of patients treated, a ceiling that included ancillary services would have to be adjusted for case mix. While extensive work has been conducted within the Health Care Financing Administration to develop a methodology for such adjustments, there is some concern about the accuracy of the diagnostic data that would be employed.

PROVIDE INCENTIVES TO STATES FOR HOSPITAL COST CONTAINMENT (A-550-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	-5	-20	-50	-95	-170
Outlays	0	90	250	460	650	1,450

Hospital costs, which increased about 15 percent a year between 1968 and 1980, rose at an even faster 19 percent annual rate during the first ten months of 1981. These increases have contributed to growing federal outlays for Medicare and Medicaid.

State programs to set maximum rates for hospital charges have been effective at restraining increases in hospital costs. The six states with mandatory rate-setting programs experienced a 48 percent increase in per capita community hospital expenditures between 1976 and 1980, compared with a 68 percent increase for other states.

The 1981 reconciliation act rewarded the six states; if their rate-setting programs continue to succeed, their federal Medicaid grants will not be reduced as much as those for states without such programs. But because this provision applied only to existing programs, it did not offer other states an incentive for initiating rate controls.

Under the option discussed here, the federal government would encourage more states to adopt rate-setting programs, by returning one-third of the resulting Medicare savings to them. This could reduce not only federal outlays, by as much as $1.5 billion during 1983-1987, but also payments by states and private purchasers of hospital care.

Savings to the federal government under this proposal would depend upon the number and size of the states initiating rate-setting programs, the effectiveness of the programs, and the details of the incentive formula. The estimate presented above assumes that states accounting for 25 percent of hospital expenditures would implement new programs in response to the proposal and that they would be as successful as the six programs already in operation. Under different assumptions, the proposal could increase rather than decrease federal outlays.

A drawback to this proposal is that the success of rate setting might come at the expense of quality of care. Stringent controls may lead hospitals to cut back the adoption of new services that have the potential to improve care. The extent of this problem in existing state programs has not been studied.

REDUCE FEDERAL SUPPORT FOR BIOMEDICAL RESEARCH
(A-550-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	370	395	420	440	470	2,095
Outlays	160	345	395	425	450	1,775

The federal government spends about $4.1 billion per year to support biomedical research, 90 percent of it through the National Institutes of Health (NIH). If appropriations for NIH research were reduced by 10 percent, the 1983-1987 savings would total about $1.8 billion.

Some believe that federal spending for biomedical research is excessive. They point to the rapid growth in federal spending in this area--about 225 percent in the overall NIH budget between 1970 and 1980, and 450 percent for cancer research in the same period. Other proponents of this budget reduction disagree that spending has been excessive, but see no valid reason for exempting biomedical research from a general need to cut federal spending.

Opponents argue that cuts of this magnitude could have long-term adverse effects on the country's biomedical research efforts. They contend that researchers unable to obtain funding would leave the field and would not be available if spending was boosted in the future.

Given the nature of research supported by NIH, it is doubtful that private funding would increase significantly to offset lower federal support. Private support for biomedical research would have to double, from $300 million to $600 million a year, to offset a 10 percent reduction in NIH funding. Most observers believe that such an increase is unlikely over the next five years.

LENGTHEN THE SOCIAL SECURITY AIME COMPUTATION PERIOD BY THREE YEARS
(A-600-a)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	10	100	200	300	500	1,110

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security retirement benefits are based on workers' Average Indexed Monthly Earnings (AIME) in employment covered by the system over most of their working lives. The number of years that currently must be included in the benefit computation formula is determined in part by the year in which the retiree reaches age 62.[1] The option discussed here, advanced by the Administration in May 1981, would add three years to the AIME computation base period, bringing it to age 65. Lengthening the averaging period would generally lower benefits, particularly for early retirees, by requiring more low-earnings years to be factored into the benefit computation. This proposal, applied for persons turning 62 after December 31, 1982, would save $1.1 billion in the next five years.

Analysts who favor a longer computation period argue that the number of years included in the calculation of AIME should be based on the age of eligibility for full benefits, not for reduced early-retirement benefits. Moreover, the shorter averaging period--which would mean that persons who retire before age 65 do not have any extra years of low or zero earnings counted in their AIMEs--might

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1. Specifically, the length of the computation period is five years less than the number of years after 1950 or attainment of age 22, whichever is later, and before age 62. Wages earned after a worker reaches age 62 may replace earnings from earlier years if this increases the benefit received.

create an incentive for early retirement. Finally, lengthening the averaging period would reduce the advantage that workers with fluctuating earnings have over those with relatively smooth earnings histories.

Opponents of this proposal view it as a means of hiding benefit reductions behind a technical change in the benefit computation. They also argue that, because many beneficiaries elect early retirement for such reasons as poor health or unemployment, a longer computation period would reduce benefits for those recipients who are least able to continue working. Other workers who stand to be disproportionately affected include women who stop or interrupt their careers to bear and raise children. The same would apply to other workers who, for whatever reasons, incurred long periods of unemployment.

DELAY THE SOCIAL SECURITY COST-OF-LIVING ADJUSTMENT BY THREE MONTHS
(A-600-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	2,800	3,400	3,300	3,400	3,500	16,400

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Under current law, Social Security benefits are adjusted each July if the Consumer Price Index (CPI) has changed by at least 3 percent between the first quarter of that calendar year and the corresponding quarter of the previous year. If the cost-of-living adjustment (COLA) were made every October instead of July, 1983 savings would amount to $2.8 billion; for 1983-1987, they would total $16.4 billion.

Over the last few years, Social Security outlays have grown both in real terms and as a proportion of both GNP and the federal budget. One can argue, therefore, that Social Security recipients should share some portion of the effort to lower federal spending. A three-month delay of the COLA would spread the reduction in benefits over the entire beneficiary population, rather than concentrate it on one group.

Opponents of delaying the COLA assert that even very small benefit reductions could cause hardships for some persons whose only source of income is Social Security. Further, if indexing delays were extended to other income support programs such as Supplemental Security Income (SSI), the recipients of which typically have incomes already below the poverty level, substantial difficulties could be caused for most program participants.

REDUCE AUTOMATIC SOCIAL SECURITY COLA TO TWO-THIRDS OF THE CPI INCREASE, BUT INSTITUTE A DISCRETIONARY SUPPLEMENT (A-600-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	5,400	9,700	14,900	20,300	26,000	76,300

NOTE: Based on change in COLA entitlements only; disregards any allowance for discretionary COLA increases.

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security recipients are currently entitled each July to cost-of-living adjustments (COLAs) based on the full percentage increase in the Consumer Price Index (CPI) between the first quarter of that year and the corresponding quarter of the previous year. In the past few years, COLAs have become a major factor in the growth of entitlement program costs in general and in Social Security benefit costs in particular. As a result, there have been a number of proposals to limit future COLAs. If the automatic COLA were limited to two-thirds of the increase in the CPI beginning in 1982, for example, savings in 1983 would be $5.4 billion. (This estimate does not include offsetting increases in income support programs, such as Supplemental Security Income (SSI) and food stamps.) Under this approach, a supplemental discretionary COLA could also be proposed by the Administration each year and voted on by the Congress. If a supplement were approved, it would reduce the savings shown in the table above.

The argument for this proposal is that it would help to control the growth of entitlement programs, while still allowing COLAs to be tailored to a year's particular economic conditions. If in a given year prices were rising faster than wages, for example, the COLA in that year could be limited to the increase in wages (as long as it was at least two-thirds of the increase in prices). At the same time, a substantial--though not full--adjustment for inflation would continue to be guaranteed.

A change from fully automatic to partially discretionary COLAs would not necessarily ensure large savings, however. Before automatic indexing of benefits began in 1975, ad hoc benefit increases generally exceeded CPI increases. For example, the total of the four benefit increases made between 1966 and 1972 raised benefit levels by 72 percent, compared with a 29 percent increase in the CPI over that period.

Under current CBO projections, limiting the COLA to two-thirds of the CPI increase through 1987 would result in a decrease in real benefits of 11.8 percent. Had this provision been in effect for the 1979-1981 period--with that period's higher inflation rates--real benefits would have been 10.1 percent lower. Such reductions could cause hardships for some Social Security recipients, especially those without other financial resources. In addition, if COLA reductions were extended to income support programs such as SSI, the recipients of which typically have incomes below the poverty level, substantial difficulties could be caused for a large proportion of beneficiaries. Since the President and the Congress would review discretionary increases each year, however, any sizable reductions in real benefits would reflect repeated decisions over time rather than a single decision.

LIMIT RETIREMENT COST-OF-LIVING ADJUSTMENTS TO CORRECT FOR PAST OVERINDEXATION
(A-600-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
			Civil Service Retirement--Function 600			
Outlays	169	572	1,005	1,415	1,799	4,960
			Military Retirement--Fuction 050			
Outlays	111	299	472	623	745	2,250
Total Savings	280	871	1,477	2,038	2,544	7,210

NOTE: Data for Social Security not available.

Several mechanisms built in at various times to the federal civilian and military retirement systems and Social Security have led to what many observers regard as excessive yearly outlays for annuities.

Military and civilian federal personnel who retire in 1982 will receive smaller pensions than their counterparts who retired during the 1970s at the same grade levels and with the same length-of-service records. For example, a military E-7 who retired in 1972 after 25 years of service now receives an annuity of $12,800; in contrast, an E-7 retiring this year after 25 years will receive an $11,400 annuity. A civilian GS-7, step 10, who retired in 1972 after 25 years receives $13,000; his 1982 counterpart will receive $9,000.

There are two reasons for such pension disparities. First, a statutory provision that applied from 1970 until 1976 caused each cost-of-living adjustment (COLA) in federal pensions to reflect not only the full change in the Consumer Price Index (CPI) but also an additional one percentage point. Although the Congress withdrew the one-percentage-point add-on in 1976, it did not make the rescission retroactive. Thus, the add-on continues to affect the size of current COLAs for pre-1977 retirees. The other reason for the pension disparity is that, in recent years, federal active-service white-collar pay has lagged behind the CPI; this is also the case for military pay, though to a lesser extent. In short, pensions have kept up with the CPI, but pay has not.

If future COLAs were held to half the CPI change for military and civilian retirees whose annuities exceeded those payable to current retirees with the same federal work histories, savings over the next five years would total over $7 billion. (For the most part, this change will affect employees who retired after 1969.) The short-run effect would be gradually to recapture the overcompensation made by the 1970-1976 indexing formula, and to eliminate the disparities caused by wage increases falling behind price increases. The long-run effect would be, in general, to limit federal retirement COLAs to the lesser of percentage changes in the CPI or federal pay.

Proponents of such a change argue that, in times of budgetary stringency, limiting future COLAs of retirees who benefited from the overindexation that prevailed for six years would be appropriate and fair; these retirees have been and otherwise will continue to be overprotected against inflation. Retirees since 1977, on the other hand, have not been similarly benefited, although they enjoyed greater protection than their counterparts still in the active federal workforce. If this greater protection continues, federal workers--particularly those at the highest grades and in periods of high inflation--would have strong incentives to elect early retirement as soon as they are eligible. This would have the dual effect of prematurely depriving the government of experienced employees and adding in the longer run to federal retirement costs.

Opponents of this option could argue that the Congress took sufficient action in 1976 in ending the overindexation of federal retirement benefits. After so many years, it would now be unfair to require annuitants to pay back extra income by limiting future COLAs. In response to the criticism that federal annuities have been rising faster than pay (thus encouraging early retirements), some observers would hold that this is a price of the Congressional policy to restrain pay raises for budgetary reasons. The solution, they would contend, is not to reduce retirees' protection against inflation, but rather to set compensation for active employees at levels that will attract and retain the desired workforce.

If the Congress decided to reduce future COLAs for federal retirees benefiting from the indexing formula abandoned in 1976, it might also look to an analogous change in Social Security benefits. The Social Security Amendments of 1972 contained a technical flaw that resulted in overindexing the initial benefits of newly eligible retirees. That flaw was corrected in 1977 Social Security legislation, but its effects persist. The flaw is in large part responsible for the recent increase in replacement rates (that is, the retirement benefit as a percentage of earnings) for workers retiring at age 65 with average covered wages, from 41 percent in 1974 to 51 percent in 1980.

As with federal retirement, the Social Security overindexing could be corrected over time by limiting future COLAs for the group affected, which is perhaps 30 percent of the Social Security beneficiary population.

Opponents of such a change in Social Security would pose some of the same arguments that federal retirees could make. In addition, the change would be extremely difficult to administer in the case of Social Security, and its effect would fall on a group with lower average incomes than federal retirees, hence on people less able to absorb a reduction in the COLA.

ELIMINATE MOTHER'S AND FATHER'S SOCIAL SECURITY BENEFITS WHEN YOUNGEST CHILD ATTAINS AGE 6
(A-600-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	50	170	300	410	530	1,460

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Under the 1981 reconciliation act, Social Security survivor benefits may be paid to a mother or a father with children under age 16, as opposed to age 18 under prior law. A further restriction of parental eligibility to cases in which the youngest child is under 6 would reduce Social Security outlays by about $1.5 billion during the 1983-1987 span. This proposal, which would apply to families becoming eligible after September 1982, would not affect the surviving child's benefit, nor the one-third of these families who would still receive the family maximum benefit.

The rationale for this proposal is that the role of women has changed substantially since these benefits were added to the Social Security system, and one can no longer assume that surviving mothers of school-aged children will not be employed. In fact, some analysts argue that it has become the norm for mothers with no children younger than 6 to work; thus, the benefits are no longer so necessary as they once were. This rationale has been used, for example, to impose a requirement that AFDC recipients with no children under age 6 register for work. Furthermore, under current law, survivor households may suffer a substantial decline in income when the youngest children reach age 16. If the surviving mother has not worked before, she may be forced into the labor market quite late in life, which may result in both relatively low wages and reduced opportunities to accumulate entitlements to pension benefits based on her own employment.

Elimination of survivor benefits to mothers and fathers of older children could be opposed on the ground that survivors' benefits are an integral part of the Social Security program. This proposal could result in major financial hardships for many beneficiary families, with perhaps as many as 15 percent of those affected suffering an income loss of 20 percent or more. In addition, child-care services for after-school hours may be inadequate, and this may limit employment opportunities for mothers of older children to part-time jobs. Finally, in families with no children under age 6 at the time a parent dies, the immediate reduction in income could cause drastic changes in the family's standard of living. One way to mitigate this proposal's effect on such families would be to provide benefits to the surviving parent for the first two years following the death of his or her spouse, even if the youngest child is over age 6.

INDEX "BEND POINTS" IN THE SOCIAL SECURITY BENEFIT COMPUTATION FORMULA BY ONLY 50 PERCENT OF WAGE INCREASES OVER FIVE YEARS (A-600-f)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	25	200	500	1,000	1,900	3,625

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security retirement benefits are calculated by applying a three-stage formula to a summary measure of a worker's lifetime earnings, called Average Indexed Monthly Earnings (AIME). For a worker retiring at age 62 in 1982, for example, the basic benefit (before actuarial reduction) would be equal to 90 percent of the first $230 of AIME, plus 32 percent of AIME between $231 and $1,388, plus 15 percent of AIME over $1,388. The points at which these percentages change--$230 and $1,388--are known as "bend points." These points are currently indexed to the annual change in average covered wages, and so they rise every year by the same percentage as wages.

Under a plan similar to one proposed by the Administration in May 1981, the bend points would be raised by only half of the increase in average earnings each year for the next five years. For most recipients, this would mean that a larger proportion of their AIMEs would fall into the upper brackets of the formula, in which the percentage of AIME "replaced" by benefits is the lowest; average benefits would therefore decline relative to current law. Almost all new Social Security beneficiaries would be affected, with the largest relative declines experienced by persons with the highest covered earnings. On average, new benefit awards would be lower by about 10 percent over the next five years than if current law were continued.

The major arguments in favor of this proposal are that it would generate very large long-run savings in Social Security outlays while maintaining payments to persons with very low benefit levels. Total savings under this proposal would solve most of the Social Security system's projected long-term financing problems.

On the other hand, this proposal would affect only new beneficiaries, who are already expected to have lower wage replacement rates than those who retired in the late 1970s; thus its enactment would widen disparities between these two groups. In addition, benefits for recipients with high covered earnings, which are already lower relative to total contributions than are benefits received by workers with low earnings, would decline further.

RETAIN EARNINGS TEST FOR SOCIAL SECURITY BENEFICIARIES AGED 70 AND 71
(A-600-g)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	400	570	610	650	690	2,920

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security benefits received by retirees younger than age 72 are subject to an earnings test; this reduces benefits by $1 for every $2 earned above an exempt amount ($6,000 a year in 1982 for beneficiaries aged 65 to 71). The age at which benefits are no longer reduced for earnings had been scheduled to fall to 70 in 1982, but the 1981 reconciliation act postponed the change until 1983. Savings of about $2.9 billion would result from a further postponement, to 1988 or later.

Advocates of continuing to postpone the reduction to age 70 argue that working Social Security recipients generally have higher incomes than most other beneficiaries; thus, working recipients may be better able to adjust to the withdrawal of an expected liberalization in benefits. Retention of the earnings test can also be supported on the ground that persons with significant earnings are not in fact retired; accordingly, they should not be entitled to full Social Security benefits.

On the other hand, another postponement of the scheduled change might discourage older workers from seeking employment. If the earnings test were removed for those aged 70 to 72, with the overall labor force expanding as a result, some additional payroll and federal income tax revenues would be generated. Such an increase in tax receipts might be small, however, since most people over 70 face substantial obstacles to employment because of poor health and limited job opportunities.

ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGED 62-64
(A-600-h)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	30	200	400	500	600	1,730

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

The child of a retired worker, as long as he or she is unmarried and under age 18, is currently eligible for Social Security benefits; the benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, the savings would total about $1.7 billion over the next five years. Some 150,000 beneficiaries would be affected.

The rationale for eliminating children's benefits while a retiree is younger than 65 is that it would encourage some retirees to stay in the labor force longer. Benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, but children's benefits are not reduced. Further, the younger workers are, the more likely they are to have children under 18 years old; thus, there may be an incentive for workers under age 65 to retire while their children are still eligible for benefits.

On the other hand, in many cases only a small reduction in benefits would result from this proposal because of the operation of the abovementioned family maximum. The maximum varies from 150 percent to 188 percent of the parent's basic benefit and would therefore affect most households with more than two recipients--a worker and spouse, for example--receiving benefits based on the same earnings record. Thus, the increase in a household's total benefits attributable to the presence of eligible children would generally be quite limited, and the work disincentive effects of these benefits might not be large.

Elimination of children's benefits could cause some hardships for young children's parents who retire early because of poor health or unemployment. This problem could be addressed by a partial measure, such as retaining the benefit but making eligibility for it subject to a means test.

LIMIT COMBINED FEDERAL DISABILITY BENEFITS
(A-600-i)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	400	400	450	450	450	2,150

a. Changes in budget authority are not presented because rapidly declining Social Security trust fund balances make the interest payments that result from these savings uncertain.

Workers who became entitled to Social Security Disability Insurance (SSDI) benefits before September 1981 can collect payments--without reductions--while also receiving benefits under one or more of the following federal programs: veterans' service-connected compensation, military disability retirement benefits, civil service disability retirement benefits, and black lung program (Part B) benefits. Approximately 6 percent of SSDI beneficiaries--165,000 people--receive duplicative payments from these other programs. Almost one-half of them were awarded federal payments greater than their average highest pre-disability, pre-tax earnings. If the combined benefit were limited to 80 percent of average pre-disability earnings, 1983 savings would be $400 million and cumulative savings over the 1983-1987 period would approach $2.2 billion.

The 1981 reconciliation act imposed just such a cap on combined disability payments of certain SSDI beneficiaries--those disabled after February 1981. The intent was to improve work incentives and to promote equity in family benefit levels, which vary widely among beneficiaries of different programs, while reducing high benefit levels. But the law did not apply to payments of current beneficiaries, nor to recipients of veterans' compensation. Extending the 1981 law to cover these persons would bring about uniform treatment of current and future beneficiaries. The option would affect about 97,000 persons in 1983.

Opponents of the proposal argue that current beneficiaries count on these benefits and might face hardship if they were cut.

In addition, they suggest that the plan would be difficult to carry out, since most benefits to dual recipients would require recalculation. Others argue that the nation owes more to veterans disabled as a result of service than to other disabled persons, making the suggested limitations inappropriate for veterans.

CHANGE CIVIL SERVICE RETIREMENT COST-OF-LIVING ADJUSTMENTS (A-600-j)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	38	279	610	919	1,240	3,086
Outlays	273	904	1,617	2,350	3,103	8,247

Cost-of-living adjustments (COLAs) for some 1.8 million civil service annuitants are paid by the government each year and recover 100 percent of the increase in the Consumer Price Index (CPI). The federal retiree COLA is superior to most such adjustments available to private-sector annuitants, and in recent years has resulted in percentage increases for retirees that exceed the percentage pay increases for active white-collar employees. If private-sector practices were followed, federal COLAs would average 33 percent of the change in the CPI for annuitants under age 62 and about 70 percent for annuitants aged 62 and older. Adopting such a change would yield 1983-1987 savings of $8.2 billion.

The 1981 reconciliation act decreased the frequency of federal retirement COLAs from twice a year to once. Various studies of post-retirement COLAs suggest that federal retirees will nevertheless continue to receive better protection against inflation than is generally available in the private sector. As a group, private pension plans provide COLAs that, over a period of years, may recover about a third of the CPI rise.

The typical private-sector retiree is also eligible for Social Security retirement benefits at age 62. Those benefits are adjusted annually for 100 percent of CPI rises; in combination with private pension benefit adjustments covering a third of CPI rises, the result is to offset about 70 percent of benefit erosion caused by inflation. Proponents of this option argue that it would be fair to provide similar protection to federal retirees, and no more. It follows that federal retirees under age 62--like their age counterparts in the private sector--would have their COLAs limited to 33 percent of CPI changes.

Opponents of this proposal would characterize it as arbitrary and unfair. They could argue that, if compensation comparisons are applicable, looking only at retirement benefits, while ignoring pre-retirement pay disparities between federal and private-sector employees performing similar work, is misleading. They also point out that federal annuities are subject to income tax, while Social Security benefits are not; and finally, that the federal government should be a model employer, not one bound by the substandard practices that enter into any comparison with private pension plans.

REFORM FEDERAL WORKERS' COMPENSATION PROGRAM
(A-600-k)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	52	56	54	51	47	260
Outlays	52	56	54	51	47	260

Civilian federal workers are covered by the Federal Employees' Compensation Act (FECA), similar to states' workers compensation programs covering job-related illness, injury, and death. The General Accounting Office has concluded that the FECA program is being abused, both in initial eligibility determinations and in the continuation of benefits to "medically recovered" employees.

Last year, the Administration proposed a comprehensive reform of the FECA program, the main feature of which would reduce an injured worker's maximum benefit from 75 percent of gross pay to the equivalent of 80 percent of net pay--wages less federal and state income tax withholdings and retirement contributions. Enactment of a proposal similar to the Administration's could result in cumulative five-year savings of about $260 million.

The argument for FECA reform is that current benefit levels, in combination with administrative rules and practices, have induced a volume of approved claims inconsistent with the size and composition of the federal workforce. Since 1970, the size of the federal workforce has remained relatively stable, but the number of employees in jobs most vulnerable to work-related injuries--postal and blue-collar workers--declined by about 16 percent. The number of new FECA claims filed yearly (as a percentage of total federal employment) rose about 85 percent, however, helping to push the annual cost of FECA from $118 million in 1970 to about $930 million in 1981.

Opponents of this proposal argue that the government should devote more effort to warding off questionable claims, and not lower benefits for workers with undisputed job injuries and continuing disabilities.

MODIFY CERTAIN CIVIL SERVICE RETIREMENT BENEFIT PROVISIONS (A-600-1)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
	Change Initial Benefit Calculation					
Outlays	50	160	270	380	500	1,360
	Reduce Early Retirement Benefit					
Outlays	5	20	50	90	140	305
	Increase Annuity Reduction for Survivor Coverage					
Outlays	30	90	150	210	280	760
Combined Outlay Savings a/	80	260	450	660	880	2,330

NOTE: Impacts on budget authority are not projected because benefit changes would affect CSR trust fund income levels only indirectly and not to a great degree.

a. Reflects overlapping reduction efforts.

Several benefit provisions of the Civil Service Retirement (CSR) system, which disburses annuities for retirees from federal civilian employment and their survivors, contribute to the program's relatively high costs. In 1983, CSR outlays are expected to total $22.0 billion and are projecteed to reach $31.6 billion in 1987. During this period, some $22.3 billion will be spent for new annuitants. Three possible modifications affecting benefits, if taken together and made effective in 1983 for new retirees only, could yield a five-year savings of more than $2.3 billion. The changes considered here would alter the method of calculating initial CSR benefits, reduce pensions for people electing early retirement, and increase the already extant annuity reduction that allows for survivor coverage.

The determination of initial benefits is based in part on an employee's three years of highest earnings--commonly referred to as "high three." A high-five basis is much more common in the private sector, at least for white-collar employees, and was the basis used before 1970 in computing CSR annuities. Savings from instituting a high-five basis for calculating initial CSR benefits could accumulate to $1.4 billion by the end of 1987.

Under CSR, federal employees may retire as early as age 55 with no reduction in earned benefits. This contrasts sharply with retirement in the private sector, primarily because Social Security retirement benefits cannot begin before age 62 and are reduced by 6-2/3 percent for each year the retiree is short of age 65. A reduction could be imposed for early federal retirement at reduced annuity levels, ultimately equal to 2 percent for each year an employee retires before age 65. Reductions would be phased in--over 20 years, for example--to limit cost increases associated with employees' accelerating retirement plans to avoid impending benefit reductions, and in recognition of the fact that people make long-term plans on the basis of current rules. Some observers might, however, criticize the reduction as not going far enough, since full actuarial [illegible]ctions in CSR benefits would equal approximately 57 percent at [illegible] 55, 36 percent at age 60, and 24 percent at age 62. But even the lesser reduction discussed here--a major departure from the early-retirement provisions of current law--would make possible a five-year savings of $0.3 billion.

In order to provide survivor coverage for their spouses, federal civilian retirees may elect reductions in their initial annuities equal to 2.5 percent of the first $3,600 otherwise payable, plus 10 percent of amounts above $3,600. This reduction is the same for all annuitants, regardless of the ages of retirees and spouses. To conform with private-sector practices, the CSR reductions for survivor coverage could be based on actuarial factors that would determine each reduction according to the actual ages of the retirees and their spouses. This would not only lead to 1983-1987 savings estimated at $0.8 billion, but also would correct the inequity in the current system: as a group, married retirees electing spouse coverage receive higher benefits in the long run than other retirees not making or having the same choice, including both married and single employees with identical work histories.

CONFORM CERTAIN CIVIL SERVICE RETIREMENT PROVISIONS TO RECENT SOCIAL SECURITY ADJUSTMENTS
(A-600-m)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	15	26	36	45	50	172

a. Impacts on budget authority are not projected because benefit changes would affect CSR trust fund income levels only indirectly and not to a great degree.

The Civil Service Retirement (CSR) program provides survivor benefits to some 17,800 students between ages 18 and 22 as well as guaranteed minimum benefits to some 19,500 retirees, most of whom are foreign nationals formerly employed abroad by the U.S. Government. The CSR minimum benefit guarantees that annuitants with five or more years of service will receive a payment at least equal to the minimum amount guaranteed under Social Security--at present, some $122 per month for new retirees.

The 1981 reconciliation act eliminated both types of benefits for Social Security annuitants, but not for CSR annuitants. The Congress later reinstated the minimum benefit, however, but only for Social Security annuitants who were receiving it before January 1, 1982; in general, new retirees will not be eligible. If CSR provisions were changed to phase out benefits for student survivors, as was done for Social Security dependents, and the minimum CSR benefit were ended for new retirees, cumulative five-year savings could reach $172 million. (Elimination of student benefits in other federal entitlement programs such as military retirement and veterans' benefits could generate another $0.3 billion in cumulative five-year savings.)

The cancellation of most CSR benefits for student survivors would follow the changes recently enacted for Social Security, but the implementation schedule would lag by a year. Beginning on October 1, 1982, no new awards would be granted for student survivors; benefits for students already on the rolls would be eliminated, however, through equal reductions over a four-year period. Also consistent with the Social Security changes, student cost-of-living adjustments and summer payments would stop in 1983.

Were it not for the guaranteed minimum, the CSR annuity earned by most foreign nationals from overseas service would be based on local prevailing wages and thus would be relatively low by U.S. standards. In most cases, however, the minimum benefit has the effect of providing such individuals with post-retirement income exceeding that of active employment. If the CSR minimum were discontinued as of October 1, 1982, outlay savings could reach $11.3 million through 1987.

Proponents of eliminating the guaranteed CSR minimum for foreign nationals point out that it is much more generous than necessary to recruit and retain the desired workforce--so much so that it offers no incentive to most employees to continue working once they become eligible for retirement. Opponents of eliminating the CSR minimum and student survivor benefits believe that many individuals would face financial hardship. But similar benefits have been eliminated from the Social Security system, and there is no analytical basis for treating government retirement differently.

CHANGE PROCEDURE FOR DETERMINING SUBSIDY PAYMENTS IN THE SECTION 8 HOUSING ASSISTANCE PROGRAM (A-600-n)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	460	500	540	575	605	2,680
Outlays	0	15	30	45	65	155

By the end of 1982, the federal government will have made long-term subsidy commitments to pay a share of the shelter costs of more than 1.8 million lower-income households through the Section 8 rental assistance program. Under this program, lower-income persons can lease privately owned housing units in structures that are newly built or already existing, but only so long as the rent charged is within federally established maximums. Assisted households pay a fixed portion of their adjusted incomes toward their housing expenses--now set at 25 percent for most recipients, but due to rise to 30 percent by 1986. The federal government then pays the property owners the difference between the tenants' contributions and the actual rents charged.

Significant savings could be achieved under the Section 8 existing-housing program by altering the procedures used to determine the subsidy payments. The federal subsidy could be set at a level equal to the difference between some percentage of each tenant's income and a benchmark amount corresponding to the cost of modest-priced physically standard housing; at the same time, households would be permitted to rent units costing more than those benchmark amounts where the families were willing to pay the additional expense themselves. Under such a scheme, households renting less costly dwellings would be permitted to realize the full savings.

Such a change would give assisted families a wider range of units to choose from and could also reduce federal outlays if the subsidy caps were set at levels lower than the present rent maximums. Because the subsidy caps would no longer constrain families' housing choices, the caps could be lowered without foreclosing large shares of local housing markets. If the subsidy on future assistance commitments were capped at a level 10 percent lower than present maximum rents, outlay savings would total $155 million through 1987. Appreciably larger savings could be achieved if this change were applied to outstanding assistance commitments as well.

Although this change would expand recipients' housing choices and reduce federal outlays, it would also increase families' housing-cost burdens. Indeed, some opponents of such a change might argue that a policy offering low-income families an opportunity to rent more expensive housing while lowering their financial ability to do so would involve an unbalanced tradeoff.

FUND CHILD NUTRITION PROGRAMS WITH A BLOCK GRANT (A-600-o)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	1,330	1,450	1,560	1,660	6,000
Outlays	0	1,290	1,410	1,520	1,620	5,840

Federal outlays for child nutrition programs will reach $4.3 billion in 1982, with state and local sponsors spending about the same amount. Nine major programs, using at least 37 different reimbursement schemes, now serve more than 26 million children and are administered by a wide variety of organizations and school districts volunteering to participate. Although the Congress, through the 1981 reconciliation and appropriation acts, reduced the 1982 budget authority for these programs by about $1.45 billion (or 26 percent), they remain fragmented, duplicative, and administratively complex.

Instead of continuing the present approach, funding a block grant at 75 percent of the federal government's estimated 1983 child nutrition costs and indexing it thereafter for inflation, would reduce outlays by about $5.8 billion during the 1983-1987 period. (No 1983 savings have been included, to allow for a planning and transition period).

Proponents of this scheme argue that a block grant to the states would simplify administration, enhance state and local flexibility, and permit federal savings without reducing nutrition assistance to needy children. At present, about 12 million children from families with incomes over 185 percent of the poverty level ($13,080 for a three-person family in 1982) receive federal child nutrition subsidies. If nonpoor children no longer received benefits, block grant proposals would not necessarily result in less nutrition assistance for poor children.

Opponents argue that a funding cut of 25 percent would far exceed the savings from consolidating administration and ending the eligibility of nonpoor children. They also contend that states might continue to assist these children, so the block grant would either lead to a cutback in assistance to poor children or give rise to pressure for an increase in federal support. Since funding for child nutrition programs has already been significantly reduced, further cuts might cause reductions in services below minimally adequate levels of nutrition.

INCLUDE MINOR SIBLINGS IN THE AFDC ASSISTANCE UNIT FOR COMPUTING BENEFITS
(A-600-p)

Savings from CBO Baseline	1983	1984	1985	1986	1987	Cumulative Five-Year Savings
	Annual Savings (millions of dollars)					
Budget Authority	63	64	67	70	73	337
Outlays	63	64	67	70	73	337

Parents receiving benefits under the Aid to Families with Dependent Children (AFDC) program may choose to exclude minor children in the household from the unit used for computing AFDC payments. It can, in some instances, be advantageous for beneficiaries to exclude children who have some income, if the net effect of counting the children (and their incomes) in the benefit computation would be lower benefits for the households as a whole. Income received by such children might include, for example, child support payments, Social Security survivor's benefits, and the children's own earnings. If all such children living in the same household as siblings or half-siblings who are counted in the AFDC unit also had to be counted, savings in the AFDC program might be as high as $300 million over the next five years, and about 90,000 families could be affected by this proposal.

Total federal savings under this proposal would be much less than those shown in the table above, however, because the decline in AFDC benefits would cause an increase in outlays for both food stamps and housing assistance. These offsetting outlays could increase by as much as $35 million in 1983, and they would thus reduce the AFDC savings by roughly half.

The rationale for this proposal is that siblings living in a household with children who are currently part of an AFDC unit are, in fact, likely to be part of the same family. One can argue, therefore, that any income they receive should be included in family income for the purpose of determining benefits.

On the other hand, under this proposal, income provided for the support of a particular child--for example, by an absent parent--would be assumed to be available for the support of the recipient child's siblings and half-siblings, even if they are unrelated to the parent making payments. This could discourage some parents from contributing to the support of their children, since their payments would no longer augment the total resources available to the family. Also, the children's own earnings, even if used entirely for their own support, would have to be counted as part of total family income if the children were 16 to 18 years old and not in school. (The earnings of those children in school would continue to be exempt under this option.) Some hardships would result, if the income received by one child were not in fact available for the support of other children in the household.

END VA COMPENSATION TO VETERANS WITH 10 PERCENT OR LESS DISABILITY
(A-700-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	700	740	800	860	920	4,020
Outlays	640	740	800	860	920	3,960

Veterans' disability compensation provides benefits to veterans for service-connected disabilities based on the degree of their physical impairment. This option would eliminate benefits to veterans whose combined disability is 10 percent or less. About 700,000 veterans would be affected, practically all of whom are now paid $58 monthly; a few receive up to $69 a month. Enactment of this proposal would result in 1983-1987 savings of nearly $4 billion.

If this program is viewed as compensating for the lost earning capacity that results from injury during military service, little argument can be made in favor of retaining benefits at the 10 percent or zero percent levels. The conditions for which a 10 percent rating is assigned (such as superficial varicose veins below the knee, mild gastrointestinal ulcers that only give rise to symptoms once or twice a year, or loss of the sense of taste) do not significantly affect a person's ability to work. Zero percent ratings represent, for the most part, persons with tuberculosis that has been completely arrested. These veterans can claim no ongoing disability at all.

If, on the other hand, disability benefits are viewed as compensation for the pain and suffering of a service-related injury or disease, the degree to which earning capacity is affected is not particularly relevant.

CLOSE CERTAIN VA HOSPITALS
(A-700-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	340	350	360	375	390	1,815
Outlays	340	350	360	375	390	1,815

The Veterans Administration hospital system provides care for certain veterans, as space is available, according to the following statutory schedule of priorities:

1. Veterans with service-connected disabilities, for the treatment of those disabilities.
2. Veterans with service-connected disabilities rated 50 percent or more, for the treatment of unrelated conditions.
3. Veterans with service-connected disabilities rated less than 50 percent, for the treatment of unrelated conditions.
4. Veterans who are former prisoners of war.
5. Veterans aged 65 or older or who are unable to pay the cost of necessary care.

This option would effect a 10 percent reduction in the number of VA hospital beds by closing 30 of the smallest and least crowded of VA acute care facilities. It assumes that 40 percent of the resulting savings would be returned to the remaining hospitals to allow them to increase their patient loads and, thereby, partially offset the impact of the closings. Some of the funds would be required to pay increased beneficiary travel costs for veterans who would have to travel greater distances to a VA facility. The estimate of savings does not reflect any savings or costs that could result from the sale or conversion to another use of the closed hospitals. Nor does it reflect any offsetting increase in Medicare or Medicaid costs.

Many of the previous attempts to reduce VA medical care costs have involved reductions in funding for medical or support staffs or for equipment. Such an approach can potentially erode the quality of care provided in all VA hospitals. Closing some of the less efficient hospitals would not affect the level of care provided in the remaining facilities. Of the 30 hospitals assumed to be closed, most have fewer than 400 beds and many have occupancy rates of less than 70 percent. Since many of the remaining VA hospitals do not operate at full capacity, much of the patient load from the closed facilities could be accommodated elsewhere in the system.

Opponents of this option will argue that some eligible veterans might be denied VA care altogether as a result. While this could happen, the remaining 146 hospitals should be more than adequate to handle the needs of all service-disabled veterans, who constitute less than 30 percent of VA hospital patients. Veterans denied care would be among those in the lowest priority category, aged 65 or older or unable to pay for their care. The majority of these veterans would be eligible for assistance from Medicare and Medicaid and, therefore, should not suffer undue hardship.

DISCONTINUE DONATION OF SURPLUS FEDERAL PROPERTY (A-800-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	30	40	40	40	40	190
Outlays	30	40	40	40	40	190

The General Services Administration (GSA) disposes of surplus real property that the federal government owns but that no agency needs any longer. At present, an estimated $1.2 billion in property has been declared excess by federal agencies and has potential for disposal. Surplus property is first offered to state and local governments and to certain not-for-profit organizations, free of charge if it is to be used for purposes such as recreation, health, and education; if the property is to be used for other purposes, a price is negotiated. Remaining property is then sold publicly to the highest bidder. Donations now total about 50 percent of the value of a year's disposals, negotiated sales about 40 percent, and competitive sales 10 percent. If donations to state and local governments were discontinued, budgetary savings from additional receipts might total about $190 million through 1987.

Legislation to discontinue federal property donations would be opposed by state and local governments, already suffering loss of federal support resulting from other budget cuts. Proponents would argue, however, that the current process amounts to a GSA grant-in-aid program, and that the government's property disposal activities should instead be conducted as business dealings. Moreover, requiring purchase of property would necessitate more careful assessment of public organizations' needs and would help to ensure that property is put to the best use.

Some observers would suggest that simply eliminating property donations would not go far enough to reform GSA's disposal procedures. The General Accounting Office has found property disposals slow. The process could be shortened by improving records and program monitoring, as well as by greatly reducing the number of extensions granted for submission of bids. Other critics of the present disposal process point out that individual agencies are reluctant to review their property requirements critically and to declare excess holdings. Whether implemented administratively or through Congressional mandate, streamlined procedures and more vigorous review would meet with little opposition and could generate additional federal receipts. Any estimate of additional revenue from accelerated disposal actions is subject to considerable uncertainty in view of changing market conditions.

END GENERAL REVENUE SHARING FUNDING FOR JURISDICTIONS WITH STRONG FISCAL CONDITION
(A-850-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	910	980	1,040	1,100	1,170	5,200
Outlays	680	950	1,020	1,090	1,150	4,890

The General Revenue Sharing (GRS) program, established in 1972, provides unrestricted grants totaling $4.6 billion annually to units of local government. State governments also participated until 1981, when their share was eliminated on the ground that their fiscal condition no longer warranted general federal support. A similar approach could be used to cut GRS funding by 20 percent, saving about $1 billion a year, and end payments to local governments in relatively strong fiscal condition.

Such jurisdictions could be identified in a number of ways. Local governments with both below-average tax effort and above-average capacity to support services could be dropped. Alternatively, state governments could be invited to submit proposals for distributing GRS funds among fiscally distressed localities.

The impact of enacting this option would depend on the responses of governments losing GRS. If they chose to replace the lost funding by raising local taxes, property and sales tax revenue would likely replace income tax revenue, making the overall tax system of the United States less progressive. Many might instead reduce local services. Since the federal government is already asking local governments to assume a larger role in financing public services at a time when many are experiencing revenue shortfalls, withdrawing GRS could produce fiscal stress even in relatively well-off places.

CHARGE THE POSTAL SERVICE FOR CERTAIN RETIREMENT COSTS (A-950-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	124	209	319	424	529	1,605
Outlays	124	209	319	424	529	1,605

Most of the 660,000 active and 380,000 retired postal workers are covered by the federal Civil Service Retirement (CSR) program. Like other federal employees and agencies, postal employees and the U.S. Postal Service (USPS) each contribute 7 percent of pay for CSR coverage. The USPS also contributes enough to cover the future retirement cost increases that result from negotiated pay raises for active workers. It does not, however, pay anything toward the expense of annual cost-of-living adjustments (COLAs) for retired postal employees. Instead, the Congress annually appropriates an amount from the general fund that indirectly covers COLAs for retirees from the USPS and other federal agencies as well.

The Postal Service could be required to pay for the cost of future COLAs for its retirees. If this were done, general fund appropriations to CSR would be lower by about $1.6 billion during 1983-1987.

The argument for such a change is that the USPS is supposed to be self-sufficient (with the exception of certain direct subsidies contained in the law), and that the present funding arrangements for retired postal employees include a hidden subsidy that properly should be a cost to mail users rather than to taxpayers in general. Over five years, a 1.1 percent average increase for all postage rates would finance an end to the subsidy. For first-class postage, the estimated increase could push the rate up by one cent. The USPS would oppose the CSR cost assessment as adding to already considerable pressure on postage rate increases and as an unfair measure that applies to no other federal agencies.

Mail users could argue that COLAs for postal retirees are an expensive carry-over from before 1972, when postal workers were direct employees of the federal government. The Congress ordered continuing CSR eligibility for postal workers, and in effect prohibited the USPS from negotiating changes in retirement benefits. Mailers may argue, therefore, that charging them for such Congressional generosity would be unfair.

ACCELERATE RECLASSIFICATION OF FEDERAL WHITE-COLLAR JOBS (A-ALL-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	90	195	310	430	1,025
Outlays	0	90	185	295	415	985

In 1979, the Office of Personnel Management (OPM) estimated that as many as 11.5 percent of federal white-collar jobs, paid under the General Schedule, were overclassified and 3.3 percent were underclassified. Incorrect classification results in some employees' receiving higher or lower pay than their duties warrant. The extent of erroneous classification may increase the cost of the total payroll for white-collar employees by as much as 1.5 percent.

At present, employees whose jobs are found to be overclassified stay at their present salary levels, and for two years also receive the full annual government-wide pay raises; after two years, such employees receive only half of the annual pay adjustment, until the pay scale for lower grades overtakes them. Although OPM has issued several regulations to federal agencies, there are no statistics on how much job reclassification has actually occurred.

If the Congress mandated agencies to reclassify federal white-collar jobs and applied the 50 percent limit on annual pay increases without waiting two years, cumulative five-year savings could reach some $1.0 billion.

Proponents assert that the government should not wait to realize the more efficient use of federal funds that results from job reclassification. Opponents could argue that the expected savings are highly uncertain because of the sparse sample in OPM's survey and the nonobjective nature of job classification. The General Accounting Office recommends that, instead of downgrading jobs, federal agencies consider restructuring overgraded jobs by expanding duties and responsibilities. Such an alternative would reduce the potential budgetary savings from job reclassification.

STRENGTHEN AGENCY DEBT COLLECTION
(A-ALL-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	300	400	100	100	100	1,000
Outlays	300	400	100	100	100	1,000

The delinquent debts owed the federal government at the end of 1980 (not counting back taxes) are estimated at $15 billion. A combination of legislative reforms and a commitment of additional administrative resources could generate savings accumulating to some $1.0 billion between 1983 and 1987, a net amount after deduction of some $700 million for strengthened agency collection activities.

Any estimate of the increases in federal receipts that might result from better management of federal debt collection is subject to considerable uncertainty. The savings shown above assume enactment of legislative measures similar to a bill now pending in the Senate, S.1249. That bill includes referral of information on delinquencies to credit bureaus, interest and penalties on overdue accounts, collection of federal debt by commercial firms, disclosure by the Internal Revenue Service of debtors' addresses, and garnishment of salaries for federal employees' debts.

The proposed reforms incorporate many practices followed by private enterprises in collecting accounts overdue. Strengthening agency debt collection also offers a way of reducing the federal deficit without cutting back ongoing programs. Critics of the measures now under consideration express concern over the invasion of privacy, doubts about the practicability of collecting debts from low-income persons, and apprehension about potential abuse of centralized financial records.

APPENDIX B. OPTIONS TO INCREASE TAX REVENUES

This appendix contains discussions of 41 options to increase tax revenues over the 1983-1987 period. Most of the options represent changes in tax expenditures and other incremental adjustments to the existing tax laws. Major new taxes, as well as other significant departures from the existing tax structure, are discussed in Chapter XII of this report. All the revenue increases are relative to the CBO baseline, which projects what revenues are likely to be under current law, assuming that the economy performs as presented in The Prospects for Economic Recovery, February 1982. The actual baseline used in this analysis is summarized in Baseline Budget Projections for Fiscal Years 1983-1987, February 1982.

As with the budget reduction options, the individual tax increase options cannot be added to an aggregate total because there are often complex interactions and offsets among the options. In addition, the estimates do not include any indirect effects, nor do they assume any major behavorial changes resulting from the tax changes. Only options that would raise tax revenues are included in this appendix. Possible revenue increases that would reduce net outlays are presented in Appendix A. Unless specified otherwise, the estimates assume that the proposals under discussion take effect on January 1, 1983. The items discussed in this appendix are simply illustrative examples. The inclusion of an item in the appendix, or its omission, does not imply a recommendation by the Congressional Budget Office.

The options in this appendix are ordered according to the budget function they would affect. Each option has an identification code: the B refers to Appendix B; the three digits refer to the budget function number; and the lowercase letter is an ordering within the budget function that, by and large, follows the sequence in the budget accounts.

PHASE OUT DOMESTIC INTERNATIONAL SALES CORPORATIONS
(B-150-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.3	0.5	0.8	0.9	2.6

A Domestic International Sales Corporation (DISC) is a special corporation, established as a conduit for export sales, that is allowed to defer the payment of income tax on a portion of its profits. In many cases, the DISC is a paper corporation with no employees and no actual operations. The DISC tax subsidy actually goes to the parent or to an affiliated corporation, since the export-related profits of the parent corporation can be allocated to the DISC. One-half of the tax liability on these profits measured over a base profit level can be deferred indefinitely. The subsidy is enhanced by special intercompany pricing rules governing the allocation of income between the DISC and its related suppliers.

The tax benefits of DISCs could be reduced by phasing out the tax benefits at the rate of 25 percent a year over a four-year period, beginning January 1, 1983. This would increase federal revenues by about $2.6 billion over the 1983-1987 period. Under this plan, the accumulated tax liability on past earnings of DISCs could continue to be deferred as long as the earnings remained invested in export-related assets. Alternatively, some or all of the accumulated tax liability could be recaptured over a specified period.

The principal objective of the legislation establishing DISCs in 1971 was to increase exports as a way of improving the U.S. balance of trade and increasing domestic employment. It was intended to help offset existing tax incentives, both U.S. and foreign, that encourage U.S. companies selling abroad to establish plants abroad rather than to produce goods at home.

Some evidence suggests that the level of exports increased modestly during the 1973-1979 period because of the DISC provisions. Most of this increase took the form of one-time expansions of exports during the first few years of each DISC's operation. However, some of the increase in exports attributable to DISCs comes at the expense of non-DISC exporting companies.

Critics of DISCs contend that the subsidy has other flaws as well. They maintain that it is not flexible enough to respond to changes in the overall U.S. trade position--in particular, that it cannot be reallocated easily as prospects for growth in the exports of some commodities improve or as the need to assist ailing industries increases. In addition, other countries see DISCs as illegal tax-subsidy vehicles violating the General Agreement on Tariffs and Trade.

MODIFY TAX TREATMENT OF FOREIGN OIL AND GAS INCOME (B-270-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.2	0.5	0.6	0.6	0.7	2.6

The income earned by U.S. corporations and their subsidiaries in foreign countries is not taxed until it is returned to U.S. shareholders in the form of dividends. In addition, to avoid double taxation, a credit against U.S. taxes is allowed for income taxes paid to a foreign country.

Modifying the application of these provisions to foreign oil and gas income, as was done in the House Ways and Means Committee version of the Economic Recovery Tax Act of 1981, would increase revenues by up to $0.2 billion in 1983, and by up to $0.7 billion in 1987.

The application of the foreign tax credit to U.S. oil companies has presented a special problem, since it is often difficult to determine whether the amounts oil companies pay to foreign governments should be treated as income taxes and taken as credits, or as royalties and taken as deductions. (Credits offset actual tax payments, so each dollar of credit saves a dollar in taxes; deductions offset taxable income, so each dollar is worth no more than 46 cents in tax savings for a corporation paying the top rate of 46 percent.)

Both the Congress and the Internal Revenue Service have sought for many years to devise a satisfactory way of taxing foreign oil and gas income, but without success. The House Ways and Means Committee version of the Economic Recovery Tax Act of 1981 contained provisions (Sections 611-614 of H.R. 4242) that would have exempted foreign oil and gas "extraction" income (income from drilling) from U.S. tax, but also would have denied any deductions or credits associated with that income. Because the foreign tax credit on oil and gas extraction income is frequently large enough to offset

U.S. taxes on other foreign oil-related income, these provisions would have resulted in a net revenue gain.

Another provision of the bill would have taxed foreign oil and gas "related" income (income from processing, transportation other than shipping, distribution, services, and asset sales) earned by a controlled foreign corporation on a current basis, rather than waiting until the income was returned to the United States as dividends. A foreign tax credit would have been allowed on this oil-related income, however.

In combination, all these provisions could result in a revenue gain of as much as $500 million to $700 million a year. Modifications in the foreign operations of United States oil companies could reduce this gain, however.

While these foreign oil and gas provisions were not included in the final version of the Economic Recovery Tax Act, they could serve as the basis for a resolution of the continuing controversy over the foreign tax credit on oil and gas income, and at the same time increase U.S. tax revenues by significant amounts.

REPEAL PERCENTAGE DEPLETION ALLOWANCE FOR OIL AND GAS (B-270-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	1.6	1.9	2.3	2.4	9.0

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for major oil and gas companies and phased it down for independent producers. The percentage depletion rate for independents is 18 percent of gross income in 1982, and is scheduled to drop to 16 percent in 1983 and 15 percent in 1984 and thereafter. (The rate is 22 percent for secondary and tertiary production until 1984, when it drops to 15 percent.) Percentage depletion applies only to an average of 1,000 barrels per day for each producer. About one-fourth of oil and gas production is currently eligible for percentage depletion. Eliminating percentage depletion would increase federal revenues by about $9 billion over the 1983-1987 period.

In the absence of percentage depletion, oil and gas producers would use cost depletion, under which the actual cost of discovering and developing a well is written off over the producing life of the well. The producers would recover their investment, but no more. Under percentage depletion the allowable percentage amount can be written off every year for as long as the well is in production, thus enabling producers to shelter not only the return of their capital but part of their profits as well. When percentage depletion is combined with the expensing of intangible drilling expenses, which allows 75 to 90 percent of total development costs to be written off in the first year, the original cost of a well may be written off many times over the course of its life.

The oil and gas depletion allowance is defended as a necessary incentive for energy production, especially for independent producers who may have less ready access to capital than major oil and gas companies. But oil and gas prices have increased sharply since the Congress last considered the oil and gas depletion allowance in 1975, rising from about $8 a barrel in that year to $34 a barrel in early 1982. This increase in prices has greatly increased economic incentives to produce oil and gas. It has also increased the value of the depletion allowance, since the allowance is a percentage of gross receipts.

The 1,000-barrel-per-day limitation permits independent producers with gross receipts of more than $12 million a year to benefit from percentage depletion. Firms at that level of gross receipts would be in the top one percent of all U.S. business firms and would be unlikely to have unusual difficulties in obtaining capital.

The oil and gas industry will benefit, along with other industries, from the very large reductions in business taxes enacted in the Economic Recovery Tax Act of 1981. The increases in depreciation allowances and the investment tax credit should make large amounts of additional capital available for investment. Special incentives aimed at encouraging particular kinds of investment, such as the percentage depletion allowance, may thus be less necessary.

REPEAL EXPENSING OF INTANGIBLE OIL AND GAS DRILLING COSTS (B-270-c)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	3.5	7.7	8.4	9.0	9.6	38.2

Under standard accounting practices, the cost of acquiring or improving an asset designed to produce income over several years is recaptured by a depreciation allowance spread over the useful life of the asset. Taxpayers engaged in oil and gas drilling, however, can generally deduct the amount spent on "intangible drilling costs" in the year that the expenditure is made--that is, they may "expense," rather than "capitalize," the qualifying costs. The costs that are permitted this special treatment include amounts paid for fuel, labor, repairs, hauling, and supplies that are used in drilling oil and gas wells; the costs of clearing ground in preparation for drilling; and the intangible (that is, nonsalvageable) costs of constructing derricks, tanks, pipelines, and other structures and equipment necessary for the drilling and preparation of wells. Typically, these outlays account for 75 to 90 percent of total costs. By expensing rather than capitalizing these costs, taxes on income are effectively deferred; the difference is equivalent to an interest-free loan in the amount of the delayed tax liability. If expensing was repealed, federal revenues would increase by about $38.2 billion over the 1983-1987 period.

The major argument for repeal is that the subsidy is no longer necessary in light of the sharp increases in oil and gas prices in recent years, the decontrol of all domestically produced oil in January 1981, and the scheduled decontrol of new natural gas in 1985. Moreover, the expensing of intangible drilling costs is an inefficient subsidy since it provides the same incentive for low-risk drilling in already developed and producing fields as it does for high-risk exploratory drilling. If intangible drilling costs were required to be capitalized, the costs of dry holes could continue to be written off immediately under normal accounting rules. This standard tax treatment would give exploratory drilling a comparative advantage over developmental drilling, thereby encouraging more exploration.

Unlike the percentage depletion allowance for oil and gas, which is no longer available to major integrated oil and gas companies, the expensing of intangible drilling costs provides significant tax savings to the majors. In 1980, for example, the expensing of intangibles reduced Gulf's effective tax rate by 5.9 percentage points, Exxon's by 4.2 percentage points, Atlantic Richfield's by 6.7 percentage points, and Standard Oil of Indiana's by 5.6 percentage points.

The major argument for retaining the expensing of intangibles is that, with the substantial increases in depreciation allowances and the investment tax credit enacted in 1981, most forms of equipment now receive tax treatment that is at least as favorable as expensing, and in many cases more so. Requiring the capitalization of intangible drilling costs would thus give these costs less favorable treatment than is now accorded to investment in equipment, thereby possibly distorting some investment choices.

REPEAL RESIDENTIAL ENERGY TAX CREDITS
(B-270-d)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.7	0.9	0.9	a/	2.6

a. Less than $50 million.

The Energy Tax Act of 1978 provided homeowners and renters a tax credit of 15 percent of the first $2,000 spent on insulation, storm windows and doors, caulking, and other items that increase the energy efficiency of their principal residences. The credit applies only to residences completed before April 20, 1977, and the cumulative credit per taxpayer for any one principal residence cannot exceed $300. The credit is scheduled to expire at the end of 1985.

The Energy Tax Act also established a larger credit for the installation of solar, geothermal, or wind energy equipment in a taxpayer's principal residence. The Crude Oil Windfall Profit Tax Act of 1980 increased this "renewable energy source" tax credit to 40 percent of the first $10,000 spent, for a maximum credit of $4,000 on any one residence. The credit applies to equipment installed between April 20, 1977, and December 31, 1985.

Repeal of the residential energy credits could increase federal revenues by about $2.6 billion over the 1983-1987 period. In 1979, the latest year for which information is available, the revenue loss from the insulation tax credit was $435 million and the loss from the renewable energy source tax credit was $42 million. Eighty-three percent of the amount spent under the insulation tax credit was for insulation and storm windows or doors, and 90 percent of the amount spent under the renewable source tax credit was for solar energy equipment.

These residential energy tax credits were enacted at a time when price controls were in effect for both crude oil and natural gas. With the decontrol of crude oil prices in January 1981, and with the scheduled partial decontrol of natural gas prices, the cost of energy has risen to world market price levels for oil and is approaching those levels for natural gas. The need for additional energy conservation incentives has thus substantially diminished. A substantial portion of the revenue loss from the energy tax credits represents a windfall to taxpayers for doing what high energy prices would induce them to do in any event.

One argument against repeal is that the reward of a tax credit is more effective than high energy prices alone in stimulating conservation efforts since it is more visible, tangible, and easy to calculate than the cost savings from reduced energy use. Another argument is that many taxpayers have made their energy conservation plans on the assumption that these credits would be available until the end of 1985, so that earlier repeal might be unfair to some who have postponed making investments. If repeal were made prospective in order to allow a few months more for people to make investments, it might induce a short-term increase in demand that could drive up energy conservation prices to levels offsetting much of the tax savings from the credit.

ELIMINATE THE EXCISE TAX EXEMPTION FOR ALCOHOL FUELS (B-270-e)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.1	0.1	0.1	0.1	0.5

Gasohol, a fuel mixture that is 10 percent alcohol and 90 percent gasoline, is exempt from the 4-cents-per-gallon federal tax on motor fuels. Thus, each gallon of alcohol generates a subsidy worth 40 cents, and a barrel of alcohol leads to a $17 subsidy. The likely 1982 cost to the Treasury will be $66 million, the bulk of which will subsidize alcohol production from corn and sugar cane. The government also provides loan guarantees to facilitate the building of large-scale alcohol fuel plants. Eliminating the tax exemption would add about $0.5 billion to federal revenues in the 1983-1987 period.

The tax exemption for alcohol fuels has several drawbacks. First, especially when combined with the loan guarantee program, it leads to investment decisions that the market would not otherwise make. (With oil currently at $34 a barrel, the $17 subsidy enables producers of alcohol fuels to compete even though charging over $50 per barrel.) Second, since alcohol fuels are made mainly from corn, an upward pressure is put on corn prices as production rises. A 60,000-barrels-per-day program (the 1982 goal) would consume 7 percent of a normal U.S. corn crop. Finally, the tax exemption cuts highway trust fund revenues by over 1 percent.

There are reasons for encouraging the production of gasohol. Unlike coal or nuclear energy, it is a liquid transportation fuel. Hence it can potentially displace large amounts of oil in uses for which there is limited substitution. Moreover, in contrast to synthetic fuels, gasohol comes from proven technologies and is available now. However, for the reasons outlined above, the excise tax exemption may not be an efficient way to encourage production of gasohol.

FINANCE THE STRATEGIC PETROLEUM RESERVE WITH A PETROLEUM TAX (B-270-f)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	2.9	2.9	2.9	2.9	2.9	14.5

The Strategic Petroleum Reserve (SPR) is intended to mitigate the economic problems that would be caused by an interruption in the supply of imported oil. The oil stockpile can be considered "insurance" for oil users against unexpected, rapid oil price increases or unavailability caused by events beyond their control. Although the several billion dollars required annually to purchase oil for the SPR is off-budget, its economic impact is the same as if it were on-budget. By imposing a fee on the users of oil, the cost of this insurance program would be paid by those who could be expected to benefit most directly if the reserve is used.

One method of charging oil users this premium would be to impose a fee of 50 cents per barrel on U.S. refined oil products. An equivalent tax on imported refined products would be necessary to avoid subsidizing foreign refiners. The increase in federal revenues of almost $3 billion annually could be dedicated to the SPR or counted as general revenues.

While such a tax could generate sufficient funds for SPR oil purchases, it would result in higher petroleum and product prices, although increases would probably be less than 2 percent. These increases would marginally contribute to inflationary pressures throughout the economy. Such pressures might, however, be somewhat alleviated by the current weakness in the world oil market, which may result in short-run declines in the real price of oil. One other potential disadvantage of imposing such a fee is its effects on the international competitiveness of domestic manufacturers relying on petroleum products.

Revenues for the SPR could also be generated by establishing a fee on imported oil or a tax on gasoline. The distribution of the tax burden of such fees would vary, as would the specific effects on oil and petroleum product markets.

ELIMINATE CAPITAL GAINS TREATMENT OF TIMBER (B-300-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.3	0.6	0.7	0.8	0.8	3.2

Income from harvested timber held for at least one year before cutting is taxed at preferential capital gains rates. This special provision overrides the tax code's general denial of capital gains treatment to "stock in trade . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." (Otherwise any manufacturer could produce a product, put it on a shelf for one year before selling it, and reduce the tax owed by 60 percent.) Repealing it would add about $3.2 billion to federal revenues over the 1983-1987 period.

The current large tax preferences for timber divert investment resources to timber from more productive uses. In addition to the capital gain tax preference, the timber industry also benefits from two other favorable tax provisions, the 10 percent investment tax credit and seven-year amortization for up to $10,000 of reforestation expenditures (enacted in 1980). The timber preference disproportionately benefits a small number of large, vertically integrated wood and paper producers who can, it is argued, assign some of their taxable income from other operations to the cutting of timber, thereby increasing their tax savings from the preference.

Defenders of the timber tax preference argue that its benefits have long been capitalized into timberland prices. More stringent tax treatment would likely depress the price of timberland, hitting hard at recent purchasers who expected tax code stability. Further, nonpreferential treatment of timber income could create an incentive for timber producers to make sham sales to one another of both the timber and the land upon which it stands--with the proceeds taxed at capital gains rates--rather than selling timber directly to processors with the proceeds taxed at ordinary rates. Finally, it is argued that ordinary income treatment would be burdensome to producers because of the long development time of timber.

ELIMINATE TAX-EXEMPTION FOR POLLUTION CONTROL BONDS (B-300-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	a/	0.2	0.5	0.7	1.0	2.4

a. Less than $50 million.

In 1981, sales of tax-exempt pollution control bonds (PCBs) reached $3.9 billion, up from $2.5 billion in 1980, and accounted for approximately 7 percent of all new long-term tax-exempt bond issues. PCBs finance approximately 40 percent of all private investment in pollution control equipment. Eliminating the subsidy would add $2.4 billion to federal revenues in the 1983-1987 period.

The availability of PCBs--or any other subsidy for pollution control--can have only limited influence on a company's decision to invest in pollution control equipment. Federal pollution control regulations are highly prescriptive, so that an existing firm must choose between making the required improvement or closing.

There are several arguments against the use of tax-exempt bonds for pollution control. The large business tax cuts in the Economic Recovery Tax Act of 1981 may have reduced the need for interest-cost subsidies in general. Even if they had not, a direct subsidy would be less costly than tax-exempt bonds because it would provide benefits only to the investor in pollution control equipment. With tax-exempt bonds, bondholders and intermediaries also realize gains. Moreover, substituting direct subsidies for tax-exempt bonds would ease the strain on the municipal bond market, where interest rates have reached record highs and are approaching those for taxable issues. Finally, PCBs encourage technological inefficiency because they are available only for "end-of-pipe" capital expenditures, thereby discouraging selection of other, possibly more effective, solutions to the underlying pollution problem--such as the use of less-polluting raw materials or production processes. Direct subsidies would encourage more efficient use of resources.

INCREASE WATERWAY USER CHARGES
(B-300-c)

	Annual Added Revenues (millions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.7	0.8	0.8	0.9	0.9	4.1

The U.S. Army Corps of Engineers will spend an estimated $4.4 billion for inland navigation purposes during the 1983-1987 period. At the same time, waterway user charges (6 cents per gallon of fuel in 1982, rising to 10 cents in 1986) will generate about $330 million in receipts--less than 8 percent of projected federal expenditures.

Raising the current fuel tax to recover fully the $4.4 billion in 1983-1987 federal inland waterway costs would require a levy of more than $1.00 per gallon. Such a fuel tax would be neither an efficient nor an equitable means of recovering these costs, however. Fuel consumption does not necessarily reflect the benefits gained by individual waterway users. Moreover, significant administrative problems would accompany the imposition of such a large fuel tax.

Direct fees or tolls would be a more efficient and equitable means of generating the same revenues. Fees or tolls could be set at levels that reflect the actual costs of building, maintaining, or operating a particular waterway segment. Moreover, the use of segment tolls would mean that some marginal projects would not be built and others might be closed down. Savings would thereby result from both increased revenues and reduced outlays.

One argument in favor of increased waterway user charges is that the cost burden of waterway facilities would be shifted from the general taxpayer to the particular beneficiaries of these facilities--specifically, the barge industry, shippers, and consumers. Shifting the full costs of waterway navigation facilities to the beneficiaries would promote more efficient allocation of resources. The rates charged to shippers would more nearly reflect the true economic costs of this form of transportation. Distortions in the choice among forms of transportation resulting from taxpayer subsidies would thus be reduced.

On the other hand, full recovery of federal expenditures for inland waterways would undoubtedly result in serious disruptions to the barge industry and shippers. Full cost recovery would increase shipping costs by approximately 3 mills per ton-mile, or one-third over current average costs of 9 mills per ton-mile. In an effort to mitigate these adverse effects, however, charges might be imposed to recover only half of federal expenditures. At this level, the cumulative savings over the 1983-1987 span would be approximately $1.9 billion, and ton-mile costs would increase by about 18 percent.

LEVY USER CHARGES FOR DEEP-DRAFT NAVIGATION EXPENSES
(B-300-d)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.5	0.5	0.6	0.6	0.7	2.9

The U.S. Army Corps of Engineers spends about $500 million a year to maintain and improve ports and channels that accommodate oceangoing vessels and Great Lakes shipping. Substantial savings to taxpayers could be achieved if charges were levied on deep-draft vessels or shippers. Full recovery of federal costs would result in savings of about $2.9 billion during the 1983-1987 period.

Several different taxing mechanisms are available to recover the costs of deep-draft navigation. Most other countries charge a fee each time a ship uses a particular harbor or channel. Another approach would be a fuel tax; such a tax could easily be avoided in international shipping, though. Costs could also be recovered through taxes based on the value, volume, or weight of the cargo. (The U.S. Customs Service already collects a small tonnage tax on international shipping.)

If all federal government costs for deep-draft navigation were recovered by user fees, shipping costs would increase by about 26 cents a ton, or less than 3 percent. Such a level would probably not harm the general economy or divert significant amounts of shipping traffic to other countries or transportation modes.

One argument in favor of this option is that the Congress has broadly applied the user-charge principle to other modes of transport, including highways, airports, and to some extent inland waterways. There is no economic or technological reason why this same rationale should not be applied to deep-draft ports and channels. Arguments against this proposal include the administrative difficulty of accurately calculating federal expenditures for deep-draft navigation, the potentially disruptive shifts in traffic between U.S. ports and channels if user charges differed among ports, and the possibility of some small reductions in coastal trade between U.S. ports and transoceanic shipping.

LIMIT HOME MORTGAGE INTEREST DEDUCTION TO $5,000 (B-370-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.8	5.5	7.3	7.4	8.8	30.8

Home mortgage interest payments have always been deductible under the federal income tax, thus providing a large and popular subsidy for homeownership. Limiting the deduction to $5,000 a year would add $30.8 billion to federal revenues in 1983-1987. Limiting it to $10,000 would add about $5.5 billion.

Opponents of a limitation hold that, because the deduction stimulates homeownership, it promotes better home maintenance and greater civic involvement. Moreover, the subsidy it provides has been widely incorporated into prices and investment decisions throughout the economy and could not be eliminated without causing significant short-term losses and economic dislocation.

Recent economic studies suggest, however, that the deduction may have important adverse consequences both for housing markets and for the economy as a whole. Aside from reducing federal revenues, it appears to have weakened the demand for rental housing, thereby encouraging a decline in new rental construction and the conversion of existing rental units to condominiums and cooperatives. In addition, the deduction has promoted the rapid rise of home prices and encouraged the flow of individual savings into housing rather than into productive capital.

Many homeowners receive little or no benefit from the deduction. As recently as 1978, more than 60 percent of all homeowners either had no mortgage or used the standard deduction and thus gained no direct benefit from the mortgage interest deduction. Of those with mortgages, only 62.5 percent claimed the deduction.

If the Congress wished to reduce the revenue loss from the deduction, the simplest option would be to limit the amount of mortgage interest that could be deducted. If the ceiling was set high enough, most homeowners would not be affected. At the same time, price increases for more expensive homes would tend to moderate and the incentives for condominium conversion would decrease. For example, a ceiling of $5,000 effective January 1, 1983, would produce savings of about $1.8 billion in fiscal year 1983 and $5.5 billion in 1984. At 1981 income levels, this ceiling would affect about 5.7 percent of all taxpayers and 19.6 percent of those now taking the deduction, although the percentage of first-time homebuyers and recent purchasers would be considerably greater. Homeowners with a 12 percent mortgage would be affected only if their mortgage principal was over $41,650.

A $10,000 ceiling on the mortgage interest deduction would save $300 million in fiscal year 1983 and $1.0 billion in 1984, but it would also affect many fewer persons--0.6 percent of all taxpayers and 2.2 percent of those now taking the deduction. Homeowners with a 12 percent mortgage would only be affected if the principal was more than $83,500. At lower interest rates, mortgages with higher principals would be shielded from a tax increase; at higher rates, lower principals would be shielded.

Applying such limits only to new homeowners or newly purchased homes would lessen the immediate effects of any change. This could lead to a variety of perceived inequities, however. Most important, it would exempt from the ceiling those who have benefited most over the years from the tax treatment of homeownership and fixed-interest-rate mortgages, while imposing a tax on new purchasers for whom the financial advantages of homeownership have already been eroded by mortgages with high and variable interest rates.

Another way of limiting the immediate effect of a ceiling on deductions would be to set the ceiling even higher than $10,000, or to postpone its actual effective date until some time in the future. Either approach would allow people time to make reasonable adjustments in their homebuying and financial plans.

TAX 10 PERCENT OF THE CAPITAL GAINS ON HOME SALES
(B-370-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	a/	0.3	0.3	0.4	0.4	1.4

a. Less than $50 million.

Capital gains on home sales are not taxed so long as a new home costing at least as much is purchased within two years of the sale of the former. In addition, the first $125,000 of capital gains on a home sold by a person age 55 or over is not taxed at all. Replacing these provisions with a tax on 10 percent of long-term capital gains could add about $1.4 billion to federal revenues in the 1983-1987 period.

The provisions were intended to prevent hardships for owners selling their homes. Deferring the capital gains tax avoids putting an additional burden on owners who have to sell because of an increase in family size or an employment change. The $125,000 exclusion for those over 55 obviates a large tax after a lifetime of home price increases, much of it attributable to inflation.

In recent years, homeownership has come increasingly to be viewed as an excellent financial investment, competing with other forms of investment for financial resources. To the extent that the tax system favors capital gains from homeownership over capital gains from stock and other forms of business investment, savings are diverted from productivity-enhancing capital investments into housing.

Replacing the present deferral and $125,000 exclusion provisions with a small tax on long-term capital gains on housing would make the treatment of housing more like that of other assets. Ten percent of the gain on all home sales could be included in taxable income, for example, compared with the 40 percent that now applies to other long-term capital gains. This lesser percentage would take account of the fact that only a portion of the gain on housing represents true investment gain, since homes are still purchased primarily as places to live. If 10 percent of the gain were taxed, the tax on the total gain would never exceed 5 percent, and would be less for taxpayers with marginal rates below the top 50 percent rate. This option would simplify both tax administration and taxpayer compliance by reducing the need for homeowners to keep track of gains and expenses on a lifetime of principal residences.

If the option applied to all accrued capital gains rather than just those occurring after the date of enactment, it would have some of its largest effects on those who owned homes at the start of the 1970s, and who benefited from the fixed-interest mortgages and rapidly increasing home prices that made homeownership such a good investment during the past decade. If only gains occurring after the date of enactment were taxed, the option would affect mainly new home purchasers who face an environment in which mortgages with high and variable interest rates have made homeownership a less desirable financial investment. Applying the tax just to gains occurring after the date of enactment would be administratively difficult, however, since there is no convenient, noncontroversial method of allocating the accumulated gain between pre- and post-enactment periods of ownership. The estimated revenue increase given above assumes that 10 percent of all accrued gains are taxed at the time of sale.

TERMINATE DEDUCTIBILITY OF CONSUMER INTEREST PAYMENTS (B-370-c)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.2	7.8	8.1	8.5	9.6	35.2

Current law allows taxpayers to deduct all interest expenses on consumer and other non-business loans. The deduction is primarily used by middle- and upper-income households; 65 percent of the tax savings go to the 18 percent of taxpayers with $30,000 to $100,000 of adjusted gross income. Terminating the deductibility of interest other than that on mortgage, business, and investment loans would increase federal income tax revenues by about $35.2 billion in the 1983-1987 period.

Opponents of the deduction argue that it encourages buying on credit and discourages saving and thrift, particularly in times of inflation. In recent years, it has been cheaper to buy by borrowing at a high but tax-deductible interest rate than to save at a high but taxable interest rate and pay cash at an inflated price later.

Defenders of the deduction point out that limiting the deductibility of consumer interest would present significant practical and administrative problems. For example, if interest on mortgage loans continued to be deductible, taxpayers could take second mortgages on their homes and use the proceeds for consumption. Moreover, the change would have different impacts on different sectors of the economy. Financial institutions lending to consumers would probably lose some business, as would producers of credit-dependent products such as autos and major appliances. Permitting exceptions such as interest on auto loans could lessen the economic impact, but it would also increase the administrative difficulties and limit the revenue gain.

Permitting deductibility of interest on auto loans plus up to $1,000 of other interest would soften the impact on the affected sectors, but reduce the revenue gain to $0.2 billion in 1983 and $1.7 billion in 1987.

ELIMINATE TAX EXEMPTION FOR SMALL ISSUE INDUSTRIAL REVENUE BONDS (B-370-d)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.7	1.2	1.8	2.5	6.3

Tax-exempt small issue industrial revenue bonds (IRBs) are issued by state and local government agencies, but their practical effect is to subsidize private businesses by enabling them to borrow for plant and equipment at low municipal bond interest rates. IRBs were used infrequently before the 1960s, when a growth in sales to $1.8 billion led the Congress in 1968 to limit their use to purposes specified in the law, such as pollution control, or to "small issues" ($10 million or less) regardless of purpose.

Small issues are used to finance a wide variety of enterprises, from manufacturing plants to tennis courts. In 1980 alone, they amounted to more than $8.4 billion (up from $7.1 billion in 1979), accounting for about 15 percent of all 1980 long-term tax-exempt bond issues. Preliminary indications are that the volume of IRB issues in 1981 may have been as much as 40 percent greater than in 1980. The continued growth of IRBs is adding to pressures on municipal bond rates, which in recent months have not only climbed to historic highs, but have also risen more rapidly than conventional interest rates. As a result, the savings generally realized from tax exemption have diminished and the relative costs to municipalities of financing public works have risen. Eliminating the tax exemption would add about $6.3 billion to federal revenues in the 1983-1987 period.

The volume of small issue IRBs, with a fiscal year 1982 revenue loss approaching $1.6 billion, raises the question of under what circumstances the federal government should subsidize the borrowing costs of private industry. Unlike federal programs to assist private business directly, IRBs are not as a rule limited to specific geographic areas in need of economic development assistance nor to specific businesses that have difficulty obtaining conventional credit.

The advocates of continued tax exemption for small issue IRBs maintain that the bonds stimulate investment and promote job development. Opponents argue that, since not all projects are eligible for IRB financing, the primary effect of the interest subsidy is on the allocation of investment dollars rather than on the total amount of investment, which is much more likely to increase in response to general business tax cuts.

LIMIT BUSINESS MEAL AND ENTERTAINMENT DEDUCTIONS TO 80 PERCENT OF AMOUNT SPENT

(B-370-e)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.3	0.6	0.6	0.7	0.7	2.9

Firms are allowed to deduct the full amount spent on business meals and other forms of entertainment as an "ordinary and necessary" business expense if the meal or entertainment is directly related to or associated with the firm's business. Limiting business meal and entertainment expense deductions to 80 percent of the amount spent would increase revenues by an estimated $2.9 billion in the 1983-1987 period.

This deduction has been the subject of continuing controversy, with opponents arguing that it provides a government subsidy for personal pleasures that have only a remote business purpose, and defenders arguing that the conduct of business is greatly facilitated by such expenditures. The Kennedy Administration in 1961-1962, and the Carter Administration in 1978, both proposed major cutbacks in business meal and entertainment deductions, but opposition from hotel, restaurant, and resort industry organizations and their workers prevented significant changes.

For tax purposes, it is often difficult to draw a line between ordinary and necessary business expenses and nondeductible personal expenses. If the line were drawn at expenses that serve the personal pleasure, comfort, or convenience of business executives and employees, for example, many common expenses such as extra-large and expensively furnished offices, company automobiles and airplanes, and expensive midtown hotels for traveling executives might become nondeductible. Limiting deductible meal expenses to a specific dollar amount would not take into account the wide variation in restaurant meal costs, and would not in fact distinguish business from nonbusiness meals.

To avoid these line-drawing problems, but at the same time place some limits on the government subsidy for business meals and entertainment, deductions for these expenses could be limited to, say, 80 percent of the amount spent. In the case of corporations, which have a top marginal tax rate of 46 percent, the government would then in effect pay 36.8 percent of the cost (46 percent times 80 percent) rather than 46 percent as now. Because businesses would have to pay a larger share of the cost of meal and entertainment expenses, they would likely impose somewhat tighter internal controls on these expenses. Firms themselves would have to consider more carefully whether the expense in question was closely enough related to an important business purpose to justify it.

INCREASE AVIATION USER FEES
(B-400-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.7	1.1	1.2	1.2	1.2	5.4

The federal government spent about $3.3 billion in 1981 for capital and operating expenses of the nation's air traffic system. General aviation (mainly, planes owned by firms and individuals for their own business and personal use) accounted for an estimated $890 million of the costs, but paid only about $35 million in the form of user charges, primarily through a 4 cents per gallon tax on aviation gasoline. Commercial airline travelers, through ticket taxes and other fees, have generally paid most of the costs attributed to them. In 1981, however, after the ticket tax fell from 8 percent to 5 percent, commercial airline users paid only 65 percent of the costs attributable to them.

Over the years, general aviation has paid only a small proportion of its associated costs. Even when the taxes on general aviation were at their height in 1978, general aviation paid for less than 15 percent of the costs attributable to it. Recovering all of the costs of general aviation would require that the taxes paid by private plane owners increase from 4 cents to about 80 cents per gallon of gasoline and jet fuel. Such an increase would raise the costs of flying private planes by less than 20 percent. Similarly, commercial aviation users would pay their total costs if the ticket tax was raised from 5 percent to about 6 percent. Together, these increases would raise revenues by about $5.4 billion in the 1983-1987 period. Taxpayers would continue to pay the one-sixth of air traffic system expenditures that represent costs not attributable to any one class of air traveler.

Proponents of this proposal argue that having users of the airway system pay their own way would encourage more efficient use of airports and airways, and would be more equitable as well. Opponents argue that greatly increased taxes might disrupt the general aviation industry, though the transition could be eased by using the approximately $3 billion surplus in the Airport and Airways Trust Fund to introduce increased charges gradually.

LEVY USER CHARGES FOR CERTAIN COAST GUARD ACTIVITIES
(B-400-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.7	0.9	1.0	1.0	1.1	4.7

The U.S. Coast Guard spends more than $1.1 billion a year on search-and-rescue activities, aids to navigation, marine safety, and environmental protection. Of this sum, more than 80 percent is allocated to different types of vessels and could be recovered through user charges.

For example, without navigational aids--such as buoys and other channel markings--commercial shipping in U.S. inland and coastal waters would be substantially more hazardous, difficult, and costly. The capital and operating costs of these aids could be recovered from the shipping industry, however, just as highway users (including both private and commercial users) pay for the costs of roads. The potential five-year savings from such user charges would total about $2.3 billion, or less than 2 percent of the transportation costs of all waterborne cargo.

The Coast Guard also engages in search-and-rescue operations for private mariners who are lost or otherwise in trouble; about one-half of such missions involve recreational boaters. These search-and-rescue costs (and other Coast Guard costs attributable to recreational boaters) could be recovered through registration fees on the 1.4 million large recreational boats berthed in coastal areas. Fewer than 20 percent of these boats would be charged more than $120 a year. Smaller fees of up to $10 a boat could be assessed on the more than 10 million recreational boats in inland waters. Other fees could be assessed on commercial and fishing vessels.

The argument for charging the shipping industry for navigational aids is that efficiency is enhanced when users of various modes of transportation pay the full costs of each mode. The argument for charging recreational boaters is simply that the beneficiaries of this special service (many of whom have higher-than-average incomes) ought to bear the costs. An analogy can be drawn to property owners, who pay through their property taxes for fire services even though they rarely need such services.

An argument against imposing such user charges is the difficulty of establishing fair cost allocations among the various kinds of users. Administrative problems could also arise in collecting a new set of fees from such numerous users. The charges might also cause some slight reduction in domestic shipping and recreational boating. Given the small increase in costs implied by these fees, most effects would be minor.

ELIMINATE TAX CREDITS FOR REHABILITATING OLDER BUILDINGS (B-450-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	1.1	1.3	1.5	1.7	6.4

The Congress in 1981 enacted large tax credits for amounts spent rehabilitating older income-producing buildings. The credits range from 15 to 25 percent, depending on the age of the building and whether it is historic. They were enacted as a subsidy to encourage businesses to renovate their existing premises rather than to relocate; to encourage people to purchase and put to new use older buildings that have outlived their original usefulness; and to encourage the preservation of historic buildings.

Eliminating the tax credits altogether would save $6.4 billion over the 1983-1987 period. Alternatively, cutting the size of the credits back to 10 percent for rehabilitations of buildings over 30 years old and 15 percent for rehabilitations of historic buildings would save $300 million in 1983, growing to $750 million in 1987, for five-year savings of $2.8 billion.

The following example illustrates how the 25 percent tax credit for rehabilitations of historic buildings works. A taxpayer who buys a dilapidated historic building for $200,000 and, using borrowed funds, spends $800,000 on renovation is entitled in the first year to a tax credit of $200,000 ($800,000 x 0.25). This reduces the owner's investment cost to zero, and in the typical case the owner realizes additional first-year tax savings of about $32,000 from depreciation allowances.

Because the current tax credits are so large, they seem certain to achieve their objective and to promote a great deal of renovation. At the same time, however, their size also ensures that many owners will receive large tax savings for doing what they would have done even if the credits did not exist or were not so large. Moreover, since the credits are not generally available for rehabilitation of housing (with the exception of housing in historic buildings), they will promote the conversion of some housing to commercial use and generally draw investment funds away from rental housing. They will similarly draw funds away from some new construction that could have contributed more to the efficient operation of the economy than the renovation that takes its place.

Because eligibility for the 25 percent credit requires both state and federal approval of a project, the credit could impose heavy demands on government resources. Between 700,000 and 1 million buildings now could qualify for the credit (subject to approval of the Department of the Interior), although only about 30 percent of them are currently income producing. From 1977, when tax incentives for historic preservation first became available, a total of only 3,500 project applications has been received by the Interior Department, but a big increase in applications is expected because the tax incentives were made so much more lucrative in 1981. The Interior Department expects to receive about 2,000 applications in 1982, with each project costing $500,000 on average.

In the face of general budget cutbacks, and in light of the sizable financial benefits that the project owners stand to receive, it might be desirable, if the credits are continued, to charge applicants a fee sufficient to cover the costs of the federal certification process. These user fees make sense particularly if the alternative is a certification process so overburdened that backlogs and lengthy delays become commonplace, dampening interest in the credits, or that the federal and state reviews become mere formalities.

If the Interior Department charged $300 per application, the $600,000 so raised in 1983 would roughly defray the federal cost of processing the applications. These offsetting receipts would reduce outlays in the Interior Department budget by that amount. The states and the Internal Revenue Service would still be left with sizable costs in administering the credits, however. If applications continued to increase, as they probably will, the application fees would save the federal government substantially more in future years.

REPEAL EXTRA PARENTAL PERSONAL EXEMPTION FOR STUDENTS (B-500-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.3	0.9	0.8	0.8	0.8	3.6

Until a child turns 19, the parents can claim an exemption of $1,000 if they contribute at least half of the child's support. Beyond that age, an additional test is imposed--the child must have less than $1,000 income in order to qualify as a dependent. If the child is a student, however, the parents can claim an exemption regardless of the student's income, so long as they provide half of the support.

If the special exemption for students was repealed effective January 1, 1983, the increased federal revenues over the 1983-1987 period would total about $3.6 billion.

The rule allowing a parental personal exemption for students, even if they earn more than the amount of the exemption, was adopted in 1954. The main reason for the rule was to avoid the "notch" problem that resulted when a dependent's earnings were close to the exemption amount; an extra few dollars in earnings could deprive the parents of the exemption, costing them hundreds of dollars in extra taxes. The exemption was also justified as a way of taking into account the added costs parents incur for students.

The main argument for retaining the exemption arises from the notch problem that prompted the 1954 change. Even though parents who support nonstudents aged 19 and over also face this problem under present law, most such nonstudents earn well over $1,000 a year so that the question normally does not arise. Students, who often work only part time, are much more likely to have earnings for the year that come close to the $1,000 dividing line.

TAX SCHOLARSHIP AND FELLOWSHIP INCOME
(B-500-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.3	0.3	0.3	0.4	1.4

Under current law, individuals are generally not taxed on scholarship and fellowship income unless the income is in return for services such as teaching or research not required of all candidates for a particular degree. Like prizes and awards generally, scholarships and fellowships are difficult to classify categorically as gifts or income. Gifts are not subject to income tax on the part of the recipient, but are subject to gift tax on the part of the donor. Until 1954, scholarships and fellowships were considered income unless the recipients could prove that they were expected to provide only nominal services in return, in which case the scholarships and fellowships were considered gifts and not subject to income tax. In 1954, formal rules elaborating on this principle were enacted by the Congress, the presumption now being that scholarship and fellowship income is generally not taxable. Ending the exclusion would add about $1.4 billion to revenues in years 1983-1987.

Even though most scholarships and fellowships are considered gifts and in theory are subject to gift tax on the part of the donor, in practice virtually no gift tax is collected on these transfers. The Economic Recovery Tax Act of 1981 increased from $3,000 to $10,000 the amount that can be given to each recipient free of gift tax each year and created an unlimited exclusion from gift tax of amounts paid for tuition expenses. Moreover, most scholarships and fellowships provided to individuals unrelated to the donor qualify for the income tax deduction for charitable contributions.

The argument for taxing scholarship and fellowship income is that it constitutes an increase in the power to consume in the same way that wage and salary income does. Not to tax scholarship and fellowship income is to discriminate against those who do not attend college or graduate school, or who work their way through school rather than getting financial aid, and in favor of academics, college athletes, and other scholarship and fellowship recipients. Because the first $3,300 of an individual's income is excluded from tax ($1,000 personal exemption plus the $2,300 zero bracket amount for single taxpayers), most students would owe little or no tax even if scholarship income was fully taxed. Those professors or students whose fellowships in reality represented salaries for full-time or nearly full-time employment would, however, have incomes greater than $3,300 and would owe tax.

The primary argument in favor of the exclusion is that scholarships and fellowships are more like gifts than income. In addition, the exclusion is one way of subsidizing higher education, long a policy of the federal government. Moreover, students supported by their parents are not taxed on the amounts they receive from them for college expenses.

If taxing all scholarship and fellowship income was considered too drastic a departure from current practice, the exclusion of this income could be continued but only for undergraduate students, or with an annual limit imposed on the exclusion. Nondegree candidates are now allowed to exclude from taxable income only $300 per month of scholarship and fellowship income, and this rule could be extended to degree candidates.

TAX FRINGE BENEFITS
(B-500-c)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.5	1.1	1.2	1.4	1.6	5.8

The Congress has for several years prohibited the Internal Revenue Service from publishing regulations for the taxation of "fringe benefits," which are certain forms of nonwage employee compensation. Although fringe benefits are legally subject to tax, they cannot be taxed on a consistent basis without comprehensive regulations, and so in practice they have been excluded from taxation. Examples of such benefits are the private use of a company car, discounts on employers' products, reduced-price meals, subsidized day care, reimbursement for recreational expenditures while on business travel, tickets to sporting or cultural events, and club dues. (Some other fringe benefits, such as employer contributions for life and health insurance premiums, are specifically excluded from taxation in the law and thus do not fall into this category.)

If the Congress would permit regulations governing the taxation of these fringe benefits to be issued, the revenue gain over 1983-1987 could approach $6 billion.

At present, a taxpayer with no employer-provided fringe benefits pays the same tax as another with an equal salary and generous fringe benefits. Employees have a strong incentive to bargain for more of their compensation in the form of untaxed fringe benefits. This shrinks the overall tax base, increases the tax rates necessary for all taxpayers, and--in a continuing cycle--further increases the incentive to bargain for untaxed fringe benefits. The exemption from tax further misallocates resources by inducing employees to bargain for fringe benefits that they would not buy themselves. Thus an employee in the 30 percent tax bracket is encouraged by the tax exemption to seek fringe benefits costing the employer $1 that the employee would not buy for more than 70 cents.

Taxing some fringe benefits, such as small employee discounts, would involve collection costs greater than the revenue to be collected; but larger items could be taxed cost-effectively. In all likelihood, some fringe benefits would be converted to cash income by mutual agreement of employers and employees; this would add to tax revenues in the same way as the direct taxation of fringe benefits.

TIGHTEN THE MEDICAL EXPENSE DEDUCTION
(B-550-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.4	3.0	3.2	3.5	3.8	13.9

The 40 percent of taxpayers who itemize may claim as deductions all out-of-pocket medical expenses that in total exceed 3 percent of adjusted gross income, as well as one-half of health insurance premiums up to $150. Raising the threshold for the medical expense deduction to 10 percent and eliminating the separate deductibility of health insurance premiums would add $13.9 billion to revenues over the next five years.

The deductibility of medical expenses above 3 percent of adjusted gross income has been justified on the ground that it assists people with extraordinary and involuntary expenses. The deduction is not limited to involuntary expenses, however; it also covers the cost of cosmetic surgery, expensive rest cures, and other optional expenses. In fact, with the substantial expansion of health insurance coverage in recent years, a significant share of the out-of-pocket medical expenses now deducted are for procedures that are not generally reimbursed by insurance because they are highly discretionary. The deduction has also been criticized because it provides a larger, rather than a smaller, subsidy rate the higher a person's income.

The basic argument for increasing the threshold for the medical expense deduction is that, if the income tax system is to be used to shift part of a person's health care costs to the federal Treasury, the relief ought to be confined to taxpayers with genuine financial need. Currently, 58 percent of taxpayers with incomes in excess of $100,000 claim the medical expense deduction compared with 8 percent of those with incomes below $10,000. The average reduction in taxes for those with incomes below $10,000 was about $60 in 1981 compared with $560 for those with incomes above $100,000.

The separate deduction for health insurance premiums was adopted to encourage the purchase of health insurance; however, there is no evidence that it has had this effect. Like the medical expense deduction, it provides greater tax savings to taxpayers with higher incomes, who have less need for assistance in purchasing insurance than those with lower incomes.

TAX SOME EMPLOYER-PAID HEALTH INSURANCE
(B-550-b)

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Addition
Income tax	2.0	3.4	4.2	5.0	6.0	20.6
Payroll tax	0.6	1.1	1.4	1.7	2.0	6.8

Employees do not pay taxes on income received in the form of employer-paid health care coverage. The exclusion will reduce 1983 income tax revenues by about $18 billion--an amount comparable to total federal spending for Medicaid, the major program financing health care services for the poor. This form of income also escapes payroll taxation, costing the Social Security trust fund about $8 billion in lost 1983 revenues.

One proposal for limiting the present exclusion would treat as taxable income any portion of employer contributions exceeding $150 a month for family coverage and $60 per month for individual coverage in 1983, with the amount indexed to medical care prices. This is similar to the approach already adopted by the Congress in connection with employer-provided group life insurance. The proposal would raise income tax revenues by $2.0 billion and payroll tax revenues by $0.6 billion in 1983. Over the 1983-1987 period, the revenue increases would amount to $20.6 billion and $6.8 billion, respectively. Any "grandfathering" of existing contributions would reduce these revenue increases.

In 1983, such a limitation would affect about 40 percent of those who participate in employer-sponsored health insurance plans. Similar limitations were included in a number of bills introduced in the 97th Congress, but none was acted on.

Both health-policy and tax-policy arguments have been made for limiting this exclusion. The exclusion leads to what many consider to be overly extensive health insurance coverage, which has expanded use of health care services unnecessarily and, consequently, driven up their prices. Moreover, the provision disproportionately benefits persons with higher incomes, both because they tend to have larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets.

Opponents of taxing any portion of employer-paid health insurance argue that present health insurance coverage is not excessive and that changing the current policy would result in less insurance coverage; this might, in turn, cause some people to forgo important medical care. Also, they argue that a uniform ceiling would have uneven effects, since a given employer contribution purchases differing levels of coverage depending on several factors such as geographic location and the demographic characteristics of the firm's work force.

ELIMINATE TAX-EXEMPTION FOR PRIVATE HOSPITAL BONDS (B-550-c)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.3	0.5	0.8	1.1	2.8

The volume of tax-exempt bonds used to finance private hospital construction increased from $3.6 billion in 1980 to $5.1 billion in 1981, accounting for approximately 9 percent of all new long-term tax-exempt financing in that year. Approximately half of all new hospital construction is financed with tax-exempt bonds. Eliminating the tax exemption would increase federal revenues by about $2.8 billion in the 1983-1987 period.

The necessity of providing subsidies for new hospital construction has come into question because at present the United States has a surplus of hospital beds. In consequence, direct federal subsidies for hospital construction have been cut back sharply in recent years.

The main argument against repealing the tax exemption for private hospital bonds is that, although nationally the supply of hospital beds may be more than sufficient, some areas still lack adequate hospital facilities. A possible solution might be to target tax-exempt hospital bonds on areas that have a shortage of adequate facilities. It can be argued, however, that tax-exempt financing is not the best way to assist such areas. Direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would then go to the institution; with tax-exempt bond financing, as much as a third of the subsidy goes to bondholders, underwriters, and bond counsel. Direct subsidies would also help to relieve the pressures on the municipal bond market, where rates have in some instances climbed high enough to erode almost completely the savings usually realized from tax exemption.

INCREASE MEDICARE PART B PREMIUMS
(B-550-d)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.0	1.5	2.1	2.8	3.7	11.0

Part B of the Medicare program, Supplementary Medical Insurance, covers a variety of medical expenditures including physicians' services and outpatient care. Participation is voluntary. Enrollees pay a monthly premium, now $11.00 but scheduled to rise to $12.20 on July 1, 1982. The remaining costs of the program are covered by an appropriation ($13.3 billion in 1982) from general revenues.

Premium receipts have covered a declining share of Part B costs each year--falling from 50 percent in 1972 to 25 percent in 1981. Under current policies, the share of costs covered by the premium will drop to 18 percent by 1987. The decline in the enrollees' contribution results because the formula for calculating premium increases reflects the previous year's increase in Social Security retirement rather than the per capita costs of Part B.

If the premium was set so that participants paid 30 percent of incurred costs per aged enrollee beginning October 1, 1982, net savings would total $0.9 billion in 1983 and $9.9 billion over the five-year period. These amounts are lower than the totals in the table since this option would also result in outlay increases in Medicaid. The estimated monthly premium would be $14.70, up $2.50 from the rate taking effect three months earlier.

This option would reduce a federal subsidy that has grown to be larger than originally planned. It should not affect the poorest of the elderly and disabled since they are likely eligible for Medicaid, which usually pays the Part B premium on their behalf. On the other hand, some elderly and disabled persons would still find the increased premiums burdensome and medical costs would consume an ever-increasing share of the budgets of Medicare participants. Some might drop Part B coverage and either do without medical care or turn to sources of free or reduced-cost care, increasing the demands on local governments.

IMPOSE A PREMIUM TAX ON PRIVATE INSURANCE THAT SUPPLEMENTS MEDICARE

(B-550-e)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	2.5	3.0	3.5	4.0	4.7	17.7

The Medicare program requires beneficiaries to share in some of the costs of care. Part A Hospital Insurance requires a one-day deductible and some coinsurance for hospitalization and skilled nursing care. In addition, it limits the number of days of insured hospitalization during a spell of illness. Part B, Supplementary Medical Insurance (mainly for physician care), also has a deductible of $75 a year, and the patient must pay at least 20 percent of charges above the deductible.

In order to reduce their out-of-pocket payments for deductibles and coinsurance, approximately 55 percent of all Medicare participants purchase (or receive from employers) private coverage to supplement Medicare. Such insurance is often called "Medigap." The plans vary widely but often pay all the cost-sharing portions of Medicare. Persons with Medigap coverage use services at a higher rate--estimated at 7 to 10 percent of Medicare costs--than those who have only the Medicare benefit package. Yet Medicare pays most of the costs of the additional use of services (for example, 80 percent of physicians' reasonable charges).

The option discussed here would recoup the extra federal outlays arising from supplemental coverage by imposing a 35 percent premium tax on Medigap policies that pay any part of the first $1,000 of Medicare cost-sharing. This proposal would not affect insurance protection for unusually large health costs. Federal savings would stem both from the premium tax receipts and from a reduction in health care use by those who would drop Medigap coverage because of the increase in its cost. Revenues could be allocated to the two Medicare trust funds on a proportional basis.

Savings would total $2.5 billion in 1983 and $17.7 billion over the 1983-1987 period. The table attributes the entire savings to increased revenues; in actuality the savings would be split between outlay decreases and revenue increases.

This option would lead to more equal government aid for all participants by requiring those with Medigap coverage to bear the additional costs they impose on the Medicare system. Elderly and disabled persons with the lowest incomes would not be affected, for they have no reason to buy Medigap coverage; their deductibles and coinsurance are paid by Medicaid.

On the other hand, the Medigap premium tax would discourage the purchase of supplemental coverage. Some who would otherwise have purchased it would face difficulties in meeting out-of-pocket costs during a year of unusually high medical expenditures.

REPEAL THE CASUALTY LOSS DEDUCTION
(B-600-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.1	0.9	1.0	1.1	1.2	4.3

Under current law, taxpayers who itemize their deductions may deduct losses caused by fire, storm, shipwreck, or other casualty, or theft, to the extent that the taxpayer is not reimbursed for the loss through insurance, disaster assistance, or other compensation. In 1964, the Congress limited the deduction to the amount of each loss in excess of $100.

If the deduction was repealed, revenue would increase by about $130 million in 1983 and by about $4.3 billion during 1983-1987.

The main argument for allowing the deduction is that taxpayers who suffer large, unpredictable, and unavoidable losses of personal property have a diminished ability to pay their federal income taxes and should thus be granted some financial assistance. Because the flow of services produced by these personal assets is not taxed, however, it is theoretically not correct to allow a deduction for the losses.

The present system has three drawbacks: it is difficult to administer, it provides an uneven kind of disaster assistance, and it creates perverse incentives. The deduction is difficult to administer because defining and valuing a casualty loss is inherently difficult. Luxury items such as jewelry, furs, and silver are included in the definition, although their loss probably does not diminish an individual's ability to pay tax. A deduction is allowed only for sudden and unexpected losses, so that two taxpayers who suffer the same final loss and hence the same diminished ability to pay tax may be treated differently depending on the suddenness of the losses. A deduction is allowed, for instance, for ornamental shrubs struck by lightning but not for the same shrubs lost gradually to winterkill.

The deduction provides an uneven disaster assistance subsidy because the assistance is granted only to those who itemize their deductions, and the amount of the assistance for a given loss increases with the taxpayer's marginal tax rate.

Finally, the current system discourages some taxpayers from taking precautions of their own against disaster--encouraging them to buy less insurance than they otherwise might.

An alternative to outright repeal would be to establish a higher floor for the deduction. Raising it from $100 to $300 would simply be an adjustment for the inflation that has occurred since 1964, and would cut the projected revenue loss by about $150 million a year.

ELIMINATE EXTRA TAX EXEMPTION FOR THE ELDERLY AND BLIND (B-600-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	2.4	2.5	2.7	2.8	11.2

Any taxpayer 65 or older or blind is permitted to claim an extra $1,000 exemption. The most widely perceived reasons for this feature of the tax law are the lower income and extra costs of living (especially medical costs) of the aged and blind. Repeal of the extra exemption would increase revenues by $0.8 billion in 1983, and by $11.2 billion during 1983-1987. Only about 15 percent of the elderly with incomes below $7,000 would suffer tax increases, averaging about $150; the average tax increase for all elderly taxpayers would be about $275.

The extra exemption is criticized on several grounds. Neither age nor blindness is itself proof of financial need; more than one-third of all 1978 tax returns with adjusted gross income of at least $1 million claimed an extra exemption for age. Other taxpayers with handicaps are not favored with an extra exemption. The elderly and blind who are in fact faced with extraordinary medical expenses can deduct them, so the extra exemption is not needed for that purpose. Because the exemption saves more tax dollars for those in the highest tax brackets, 17 percent of the tax saving goes to the 7.6 percent of all elderly and blind taxpayers with incomes of over $50,000. The elderly and blind with the lowest incomes are not taxable and do not benefit from the extra exemption; in 1978 only 11 million extra exemptions were claimed by 24 million elderly Americans.

As an alternative to outright repeal, the Congress could convert the extra exemption to a $150 credit. Elderly and blind couples with incomes under $11,600 in 1983, and single persons with incomes under $6,400, would be better off with such a credit; and those with higher incomes would at least get the $150 tax saving. Converting the exemption to a $150 credit would increase tax revenues by $0.4 billion in 1983, and by $4.0 billion through 1987.

TAX HALF OF RETIREMENT BENEFITS FOR SOCIAL SECURITY RECIPIENTS WITH INCOMES ABOVE $20,000/$25,000 (B-600-c)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.6	1.9	2.3	2.7	3.1	11.6

Social Security benefits (and most other government transfer payments) are not subject to personal income taxation. Treating half of Social Security workers' retirement benefits as taxable income for couples with incomes above $25,000 (and single individuals with incomes above $20,000) would increase revenues by about $1.6 billion in 1983 and by nearly $12 billion in 1983-1987.

The law nowhere specifies that Social Security benefits are to be tax-free; benefits have been excluded from taxation only on the basis of an Internal Revenue Service ruling at the start of the program that they were in the nature of welfare payments. (At the time, most recipients were classified as poor.)

There are several arguments for taxing half of retirement benefits for recipients with incomes above $20,000/$25,000 (which is also the current treatment of unemployment compensation). Aside from raising revenue to reduce the budget deficit, the proposal would bring the tax treatment of Social Security payments partly into line with other pension benefits, which are fully taxable after the retiree has recovered his own contributions, if any. If Social Security were taxed like private pensions, about 83 percent of retirement benefits would be taxable.

Taxing benefits would also have the advantage of improving intergenerational equity. Current Social Security recipients generally receive benefits well in excess of their past contributions, with the extra amount being financed by the taxes on the present generation of workers. The extra income tax revenues generated by the provision could be directed to the OASI fund, thereby easing the tax burden on current workers. Over the longer run, taxing benefits would probably also ease the Social Security system's financial problems by inducing individuals to work longer over their lifetimes, since after-tax retirement incomes would be reduced. Setting the threshold amounts at $20,000/$25,000 would limit the proposal's effects to those beneficiaries with the greatest ability to pay.

COVER NEW GOVERNMENT EMPLOYEES UNDER SOCIAL SECURITY (B-600-d)

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Addition
Social Security Trust Funds	0.6	2.0	3.7	5.5	7.4	19.2
Total Revenues a/	0.3	1.1	2.0	3.0	4.0	10.4

a. Represents net increases in total federal revenues assuming that new federal employees make no contribution to the Civil Service Retirement trust fund.

Government employment accounts for the largest portion of the nation's work-force not covered by Social Security; the jobs of more than 90 percent of federal workers and about 30 percent of state and local employees are not covered. If all new government employees were covered beginning January 1, 1983, Social Security net trust fund balances would improve in both the short and the long run. Over the next five years, trust fund revenues would increase by approximately $19 billion.

The eligibility requirements for Social Security and for government pensions based on noncovered employment permit many workers to qualify for both. A frequent result is that government retirees receive the advantage of features in the Social Security benefit formula that provide higher relative benefits to workers with low earnings, even though such government retirees do not actually have histories of low earnings. Mandatory coverage would end this anomaly. It would also improve disability and survivor protection for younger government employees and those who change jobs, because the vesting period for these benefits under Social Security is shorter than under most government pensions, and because Social Security coverage is more portable.

One problem that arises with Social Security coverage of new government employees is the integration of Social Security with existing government pension programs. For example, new federal employees would probably not be required to pay both the current 7 percent contribution rate for Civil Service Retirement (CSR) and 6.7 percent for Social Security. Whether or not CSR coverage for new employees would be contributory is an issue that would have to be resolved. Income to the CSR trust fund, however, would be substantially reduced under virtually all the Social Security coverage options for federal workers considered to date.

Opponents of mandatory coverage of new government employees point to several other difficulties in this proposal. First, the present system makes public employee pension programs attractive fringe benefits that may help the recruitment and retention of civil servants. Second, it is argued that mandatory coverage, by generating substantial new revenues for Social Security, would only delay more fundamental reforms of the Social Security program. Finally, the different treatment of new employees might create inequities between workers under the new and old pension systems.

TAX WORKERS' COMPENSATION BENEFITS
(B-600-e)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.5	3.8	4.5	5.5	6.7	22.0

Most workers who suffer on-the-job injuries are insured by workers' compensation. Payments are tax free and cover medical expenses and some portion of income loss. If the payments for income loss were taxed beginning in 1983, the revenue gain would be $1.5 billion in 1983 and $22.0 billion during 1983-1987.

By far the costliest part of workers' compensation is benefits for permanent partial impairment from work-related injury. Assessment of the degree of disability is necessarily inexact, and may or may not correspond to actual income loss. In some cases, it is likely that the value of the tax-free benefits exceeds the lost wages net of tax; in those cases, beneficiaries have little incentive to return to work. It is arguably unfair when one person receives tax-free workers' compensation while another earns equal amounts in wages but must pay tax.

These problems can be ameliorated through taxation of workers' compensation benefits that substitute for wages. Beneficiaries who suffer reductions of income will be protected from taxation by the standard or medical expense deductions and the personal exemption, while others who have more substantial benefits and delay their return to work will have their net compensation reduced.

Opponents of such a policy change would argue that benefit levels differ significantly from state to state, and hardships might result if low-benefit states did not increase their benefits to take account of the tax on them. Further, some beneficiaries would be subject to higher marginal tax rates than others solely because they had working spouses. Finally, because court-awarded damages for income loss due to non-workplace injuries are not subject to tax, it could be argued that it is unfair to subject similar payments to tax in the case of workplace injuries.

TAX RAILROAD RETIREMENT BENEFITS
(B-600-f)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.2	0.2	0.2	0.2	0.2	1.0

The Railroad Retirement System (RRS) is an industry-wide pension plan. It currently pays benefits to nearly one million annuitants and provides mandatory coverage for about 500,000 workers employed by 1,000 different railroad companies. Railroad retirement predates and remains independent of the Social Security program, although the two systems now have many common features and coordinate their coverage. Unlike any other private pension, RRS is managed by the federal government, and the retirement income it provides is almost entirely tax free. 1/ If the benefits were taxed like private-sector pensions, federal revenues would increase by about $1.0 billion in the 1983-1987 period.

Since 1975, RRS has been structured to parallel the two-part retirement income available to employees in the rest of the private sector: a Tier I component that both substitutes for Social Security coverage and provides certain extra benefits, and a Tier II component that compares to an employer pension and may be supplemented by longevity payments. If RRS benefits were taxed like private-sector pensions, the Social Security portion would be tax-free, but both the "extra" benefits under Tier I and the Tier II employer pension component would be taxable to the extent that benefits exceed employee contributions. Although determining the appropriate tax for each RRS annuitant would be administratively difficult, approximately the same revenue increase would be

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1. The only benefits subject to federal income tax are supplemental longevity payments for retirees with the equivalent of 25 or more years railroad service. These benefits began in 1966 and cannot exceed $840 a year. No taxes would be collected, however, unless an RRS annuitant, under age 65, had taxable income exceeding $3,300 if single and $5,400 if married and filing a joint return.

achieved by taxing 40 percent of each RRS pension. If some portion of Social Security benefits were taxed as suggested in item B-600-c, it might be appropriate to tax a larger share of RRS benefits.

The cost of this option would, of course, fall on railroad annuitants. In calendar year 1983, for example, married railroad annuitants--with RRS pension benefits ranging between $20,000 and $22,000--will otherwise receive an income tax advantage averaging some $1,200 per couple. 2/ If this proposal were enacted, this tax advantage would shrink; nonetheless, for married annuitants who are newly retired, RRS would still offer after-tax benefits that appear among the highest in private industry. Low-income annuitants would be liable for little if any additional tax payment because of the graduation of the federal income tax system.

Proponents of this option would argue that the current exclusion of practically all RRS benefits from taxable income is an historical anomaly. Treating some benefits as comparable to Social Security, and thus nontaxable, would be fair, they argue, but to exclude the remainder, which is comparable to the taxable benefits paid from other employer pension plans, is inequitable and not justified by sound tax principles.

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2. After a railroad retiree and his spouse both reach age 65, the tax advantage on the same income shrinks to about $900 because of the extra $1,000 tax exemption available to all taxpayers over age 65. Also, as a result of graduated income tax rates, the advantage of a tax-free RRS pension increases to the extent that a railroad annuitant has taxable income from other sources.

TAX ACCRUED INTEREST ON LIFE INSURANCE RESERVES (B-600-g)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.5	3.7	3.9	4.0	4.1	17.2

Premiums paid for whole life insurance policies can be divided into the price of death protection and a separate saving component. While death benefits paid by insurance companies approximately exhaust the death protection component of the premiums each year, the saving component builds up as a reserve or cash value that earns interest year by year.

Attributing interest on life insurance reserves to policyholders for income tax purposes on a current basis (even though they did not receive the interest in cash) would raise $1.5 billion in 1983, and $17.2 billion over the 1983-1987 period. About 25 million tax returns would be affected. The impact on the least affluent policyholders could be reduced by taxing only interest in excess of some floor, perhaps $100 a year. Such a limitation would likely reduce the revenue gain by about half.

In most respects, saving through whole life insurance is identical to saving through other interest-bearing instruments; the one major difference is that interest earned on life insurance reserves is not taxable until the policy matures. At the same time, interest paid by policyholders on their policy loans is deductible. While whole life insurance policies have until recently offered low guaranteed rates of return through conservative investments of premiums, new policies are now being offered with much higher rates of return to capitalize on this tax advantage. Policies can be tailored to allow the policyholders easy and early access to their funds, unlike tax-deferred IRA accounts where money must be deposited until retirement age to avoid stiff penalties.

Opponents of the exclusion of life insurance interest argue that life insurance companies can invest their policyholders' savings tax free, while the policyholder investing in the same assets directly or through a mutual fund is subject to tax. The Internal Revenue Service recently tightened requirements for the very similar so-called wrap-around annuities, but experience suggests that tax can be avoided on virtually any investment by calling it insurance and purchasing it through an insurance company according to certain technical restrictions. Such a tax avoidance opportunity is arguably unfair and inefficient.

Those who favor the exclusion of life insurance interest argue that the interest is not received in cash until the policy matures (though this is also true of some long-term bank deposit certificates, the interest on which is taxed currently). They also contend that the uncertainty of earnings would cause taxation to be a disruptive burden to the entire life insurance industry, and make whole life insurance much less attractive.

RAISE CIVIL SERVICE RETIREMENT CONTRIBUTION RATES (B-600-h)

Relative to CBO Baseline	Annual Added Receipts (billions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Addition
	Employee Contributions					
Revenues	0.4	0.9	1.4	1.5	1.6	5.8
	Payments from Off-Budget Agencies					
Negative Outlays	0.1	0.2	0.3	0.3	0.3	1.2
Total Addition	0.5	1.1	1.7	1.8	1.9	7.0

Most federal civilian employees and their employing agencies both contribute 7 percent of salary to the Civil Service Retirement (CSR) system in order to help fund future retirement benefits. These contributions, however, do not fund the cost-of-living adjustments (COLAs) received after retirement; instead, COLAs are indirectly funded by federal payments appropriated to CSR. An increase of 2 percent of pay in both the employee and employer contribution rates would fund the relatively better cost-of-living protection afforded federal civilian retirees compared with COLA protection prevailing in the private sector. If the contribution rates were gradually increased to 9 percent, in increments of 0.7 percentage points a year beginning in 1983, additional federal receipts over the five years could reach $7.0 billion. This estimate includes $5.8 billion in revenue from increased employee contributions and $1.2 billion of offsetting receipts (negative outlays) from the higher contributions that would be paid by the U.S. Postal Service and other off-budget agencies.

An increase in the CSR contribution rates would recognize that COLA provisions for federal ~~annuit~~ants are expensive and more generous than private-sector practices. Raising the contribution rates of on-budget employing agencies would have no ultimate budgetary effect, since these agency contributions are internal transactions within the budget. It would, however, improve cost accountability for CSR and, in turn, management decisions about the costs and scope of federal programs.

The budgetary reduction from this proposal would be achieved at the expense of higher postage rates (averaging about 0.8 percent for the five-year period) and lower take-home pay for federal civilian employees. Opponents would argue that mail users should not be asked to pay for post-retirement benefit changes prescribed by the Congress. They would also point out that federal employees already contribute to their pension plans at a higher rate of pay than private-sector employees do toward their anticipated Social Security retirement benefits. (Few private-sector employees shoulder any of the costs of the pensions they will receive from their employing firms.)

TAX ALL UNEMPLOYMENT INSURANCE BENEFITS
(B-600-i)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.9	1.7	1.7	1.8	1.8	8.9

Unemployment compensation paid under most government programs is treated as taxable income to individuals with incomes above $20,000 and couples with incomes above $25,000. For such taxpayers, half of each dollar of benefit payments is included in adjusted gross income. Most taxpayers receiving benefits are unaffected by the provision, however, because the taxation thresholds are so high.

Taxing all unemployment insurance benefits would increase revenues by nearly $2 billion in 1983 and by about $9 billion in 1983-1987.

Taxing all benefits by eliminating the current exclusion would be consistent with a policy of ending artificial tax distinctions between similar sources of income. Privately paid unemployment benefits have always been regarded as fully taxable since they are intended to replace lost taxable earnings. Government-sponsored payments, under this proposal, would be treated similarly. Tax payments would be based on the household's ability to pay, which the tax code already takes into account through exemptions, deductions, and graduated tax rates. As a consequence, even if benefits were taxed in full, most recipients with incomes below about $10,000 would pay little or no additional tax.

However, since existing benefit levels may be based on their nontaxability, even small tax increases might necessitate a rise in benefit levels to ensure that all taxpayers maintained a minimum living standard.

Taxing benefits would also provide an additional incentive for persons collecting benefits to seek employment. In particular, it would lessen the incentive for temporary layoffs. At present, as much as half of all unemployment can be traced to job losses involving only temporary layoffs where employers rehire former workers whose layoffs have been cushioned by unemployment benefits. Both employers and employees have an incentive to engage in this practice. Because the unemployment compensation taxes paid by employers with high turnover rates do not fully cover the extra costs they impose on the system, these employers are in effect subsidized by employers with more stable payrolls. At the same time, benefit payments to low- and middle-income workers while on layoff frequently approach after-tax income levels from working, making it easier for them to wait to be rehired rather than look for another job.

TAX FEDERAL EMPLOYEES FOR MEDICARE
(B-600-j)

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Social Security Trust Fund Income	1.3	1.7	1.9	2.2	2.5	9.6
Federal Revenues a/	0.7	1.1	1.2	1.3	1.4	5.7

a. Represents net increases in total federal revenues after accounting for internal budget transfers from federal agency contributions.

Medicare hospital insurance, which covers most of the nation's aged and disabled, is funded by a portion of Social Security payroll taxes that apply throughout the careers of most active employees. In calendar year 1982, payroll taxes for Medicare will require employees and employers each to pay 1.3 percent of the first $32,400 of earnings. Although most federal workers do not contribute to Medicare during government service, they may become eligible for Medicare benefits at age 65 if covered by Social Security or if their spouses are covered. Eventually such eligibility will require that individuals reaching age 65 have at least ten years of covered employment; at present the eligibility requirement is less stringent.

Federal retirees as well as employees may participate in a separate health care program, the Federal Employees Health Benefits (FEHB) system. For federal workers who also qualify for Medicare hospital insurance, through employment covered by Social Security, FEHB becomes a secondary source of protection, as with other health care plans in the private sector.

The National Commission on Social Security recommended in 1981 that Medicare hospital insurance be extended to federal, state, and local government employees. Making such coverage universal would reduce the subsidy many government workers enjoy because they receive full Medicare benefits but pay little into the program.

Under current law, 80 percent of the retired federal workers aged 65 or older are already covered by Medicare.

Extending coverage to federal employees would generate substantial tax revenues for the federal government and help bolster the Medicare hospital insurance fund. Under this proposal, all federal workers and new retirees would count their federal employment toward satisfying eligibility requirements for Medicare hospital insurance and they could still elect to receive FEHB benefits as a supplement. The additional Social Security taxes paid by all federal employees and employing agencies would add, between 1983 and 1987, some $9.6 billion to the hospital insurance trust fund. This additional income includes $3.9 billion of in ternal transfers from contributions paid by on-budget agencies and $5.7 billion in federal revenue from employee withholdings and contributions paid by the U.S. Postal Service and other off-budget agencies. (The estimates assume a January 1983 effective date and reflect scheduled increases in Medicare hospital insurance tax rates and the maximum earnings subject to taxation.) The increase in federal revenues would be even greater if all government employees--federal and nonfederal alike--were subject to Medicare hospital insurance taxation.

Distributing the cost of Medicare benefits among all active workers, government as well as private, has been supported as good public policy by many Social Security analysts. But limitations on annual federal pay increases since 1977, as well as dramatic increases in the 1982 FEHB premiums, have already affected the take-home pay of federal workers. Further pay check reductions could hamper the ability of the Department of Defense, which is expanding its work force, to attract and retain qualified employees. Spokesmen for federal employees and their unions argue that the timing for such an extension is wrong regardless of its merits. At a minimum, they hold that any health insurance taxation should also extend Medicare hospital insurance to existing as well as new federal retirees. Such extensions, however, would mean some increase in Medicare outlays but a dampening of future FEHB cost increases.

TAX VETERANS' DISABILITY COMPENSATION
(B-700-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	1.7	1.9	2.2	2.5	9.1

Veterans with service-related disabilities are eligible for monthly cash benefits under the veterans' disability compensation program. Benefits are paid according to the degree of disability and now range from $58 a month for 10 percent disability to $1,130 a month for complete disability, with additional payments up to $3,223 a month for eligible veterans judged to have suffered certain specific severe disabilities. Benefits are tax free and paid without regard to income from other sources. If disability compensation was made taxable, the revenue gain would be $0.8 billion in 1983 and $9.1 billion in 1983-1987.

Because payments are available for very minor disabilities, and because they are not reduced for veterans able to work, disability compensation benefits are not closely targeted to financial need. About 39 percent of all beneficiaries are only 10 percent disabled. Because a 10 percent disability can be a relatively minor medical problem, such as a scar or a small reduction of movement in a joint, earning power is oftentimes unimpaired. While those who suffered disabilities in the service of their country are surely entitled to some compensation, benefits for minor disabilities may have a lower priority in times of budgetary stringency.

Any hardships resulting from taxation of benefits could be alleviated by increasing benefits 10 percent for beneficiaries who are at least 50 percent disabled, since they receive the largest benefits and are most likely to be in need. Such an increase would make up for the tax liabilities in the worst case (a beneficiary living alone and unable to work), but would reduce the net budgetary gain by only about one-third.

Opponents of these policy changes would argue that disability compensation for those who suffered long-term physical harm in the military should not be reduced because of other income, especially if the other income is from the labor of a spouse or from property. As against this, some Members of Congress believe that benefits have been insufficiently targeted on need, and have tried without success to cut back on benefits directly. Taxing benefits has the advantage of targeting the reductions of net income on those least in need without reducing benefits directly.

ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES (B-850-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	5.3	6.0	6.8	7.8	26.7

State and local sales taxes paid may be claimed as an itemized deduction. Eliminating the sales tax deduction would increase federal income tax revenues by $0.8 billion in 1983 and by $26.7 billion in 1983-1987. Should some states choose to shift their tax collections from sales to other taxes to preserve deductibility for their residents, the revenue gain would be reduced.

Sales taxes reduce the taxpayer's net income, and thus his ability to pay federal taxes. Normally, however, only expenses that are relatively large and that vary substantially from one taxpayer to another are deductible on ability-to-pay grounds; small, uniform, and predictable expenses are ignored and implicitly taken into account when the zero bracket amount, personal exemptions, and general tax rates are established. The sales tax is such a small, uniform, and predictable expense. Sales taxes are collected in 45 of the 50 states; in 1977, the latest year for which detailed data are available, 96.9 percent of all itemizers claimed the deduction, in amounts varying only from 2.0 percent of adjusted gross income for taxpayers with $10,000 to $12,000 of income, to 0.2 percent for those with over $1 million in income. The sales tax deduction is usually a small item (less than half as large as real estate taxes and about a third of income taxes on average in 1977). Sales tax liabilities do not vary substantially from state to state.

Any ability-to-pay rationale for the sales tax deduction is further undermined by the way it is usually calculated. The deduction amounts in most cases come from printed tables based on the state and the size and income of the family, and presented in the Form 1040 instructions. The deduction is thus usually not based on actual tax payments, and does not compensate for variations in the burden among taxpayers. Further, taxpayers can only justify a deduction of actual liabilities greater than the IRS table value by documenting each of the hundreds of retail transactions they made during the year. (Alternatively, if a household made a major purchase such as an auto, it can claim the deduction from the IRS table plus a further deduction for the sales tax on the major item. Because the major purchase would likely displace some other consumption, this method probably overcorrects for ability to pay.) Thus, the sales tax deduction may be both the most imprecise and the most burdensome (in terms of recordkeeping) of all the itemized deductions.

Beyond the considerable revenue loss, the imprecision, and the complexity of the deduction, it also has unfortunate incentive effects for both taxpayers and state and local governments. For taxpayers, it marginally and indirectly reduces the cost of consumption at a time when many observers believe the nation would be better served by more saving. For state and local governments, the deduction cushions the burden of the sales tax on taxpayers; but the sales tax, because it adds to price levels, contributes to inflation at the retail level. If the states and localities shifted toward taxes that do not increase prices, this would temporarily decrease the rate of inflation directly, and indirectly reduce business costs through cost-of-living escalators in labor contracts. (Direct reductions of sales taxes would, of course, make consumption even more attractive.)

Advocates of the sales tax deduction argue that the federal government should not influence the states' choice of taxes through selective deductibility. Another argument is that use of the sales tax, popularly held to be a fair tax, should not be discouraged.

LIMIT TAX CREDIT FOR POSSESSIONS CORPORATIONS
(B-850-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.2	0.4	0.5	0.5	0.6	2.2

"Possessions corporations" are companies incorporated in the United States that are exempt from U.S. income tax on their operations in Puerto Rico, American Samoa, and Guam. Ninety-nine percent of the revenue loss is attributable to Puerto Rico.

The revenue loss from this exemption--currently estimated to be $1.3 billion in 1983 and $1.8 billion in 1987--could be cut by about one-third, without significantly limiting the job-creation effects of the provision, by eliminating the incentive for U.S. companies to transfer their high-profit patents and other intangible assets to Puerto Rico in order to shelter the profits from tax. Such a change would increase revenues by $200 million in 1983, and by $2.2 billion in 1983-1987.

The exemption was originally enacted in 1921, mainly to provide U.S. firms doing business in the Philippines, then a U.S. possession, with the same favorable tax treatment enjoyed by their British competitors. In 1975, the House Ways and Means Committee considered repeal of the exemption on the ground that its original purpose was no longer being served, since the Philippines had ceased being a U.S. possession in 1946. Proponents of the exemption argued, however, that it had become crucial to the economic development of another U.S. possession, Puerto Rico. A large number of U.S. firms had established plants in [illegible] Rico after Puerto Rico enacted special tax exemption provisions of its own in 1948, and it was argued that these firms were [illegible] primary source of jobs in Puerto Rico. It was also argued that the loss of revenue from the provision was quite modest--about $200-500 million a year --and that this was a small price to pay for the benefits achieved. The Tax Reform Act of 1976 narrowed the possessions corporation exemption somewhat, and required that the Treasury Department report annually on the "operation and effect" of the exemption.

The most recent of these annual reports, released in June 1980, showed that the revenue loss from the exemption was much larger than originally estimated. A loss of $1.1 billion was expected in 1982, increasing to $1.5 billion in 1985. Almost 50 percent of the revenue loss in 1978 was attributable to the Puerto Rican operations of 16 large U.S. pharmaceutical companies, according to the Treasury report. Relative to their profits, pharmaceutical possessions corporations employed few people; the annual revenue loss per pharmaceutical company employee in 1978 was an estimated $43,261, while average compensation in Puerto Rico per pharmaceutical company employee was estimated at $13,618. For all 390 manufacturing companies benefiting from the exemption, the federal revenue loss per employee in 1978 was estimated to be $12,667, compared with average employee compensation of $10,697. The Treasury reports suggest that a major effect of the exemption in the 1970s has been to induce U.S. firms to shift high-profit, low-labor activities to Puerto Rico, with relatively few benefits to the Puerto Rican economy.

Defenders of the exemption argue that it is crucial to long-term Puerto Rican economic growth, that the job loss and economic dislocation that would result from repeal would impose additional costs on the U.S. and Puerto Rican governments, that 1981 federal budget cuts have already put an inordinate burden on Puerto Rico, and that the exemption is an important underpinning of the U.S.-Puerto Rican political relationship. A further consideration in evaluating the tax credit is that the large general business tax cuts enacted in 1981 have eroded to some extent Puerto Rico's comparative tax advantage for U.S. companies.

The efficiency of the possessions corporation tax credit could be increased if it were limited to investments that created substantial numbers of new jobs. As the Treasury reports have indicated, the revenue loss per employee for pharmaceutical companies is more than four times larger than the average for all other manufacturing industries. This is largely because the pharmaceutical companies have transferred many of their high-profit drug patents to their subsidiaries in Puerto Rico, and have then used the possessions tax credit to shelter the profits on the patents from U.S. tax. This tax avoidance practice could be reduced or eliminated by requiring that a U.S. corporation transferring patents, trademarks, and other intangible assets to a possessions corporation include in its taxable U.S. income the full "arm's length" price of the intangible assets. This requirement could be applied to intangible assets previously transferred to Puerto Rico, leaving it to the companies involved to decide whether to continue the current division of assets under the new terms.

APPENDIX C. ASSUMPTIONS USED IN NATIONAL DEFENSE PROJECTIONS--QUANTITIES OF WEAPONS PROCURED UNDER CBO BASELINE, POSSIBLE ADMINISTRATION PROGRAM, AND ALTERNATIVE

TABLE C-1. QUANTITIES PROCURED UNDER "LEAPFROG THE B-1 BOMBER AND PROCEED DIRECTLY TO AN ADVANCED TECHNOLOGY BOMBER WHILE INCREASING B-52 ALERT RATES"

	Fiscal Year					To
	1983	1984	1985	1986	1987	Complete
CBO Baseline						
B-1	7	9	36	46	46 a/	N/A
Possible Administration						
B-1	7	9	36	46	46 a/	N/A
Alternative						
B-1	0	0	0	0	46 a/	N/A
Accelerate ATB development						
Increase B-52 alert rates from 30 to 40 percent						

a. While B-1 purchases in 1987 are not likely, they are included to provide funds for procurement of the ATB. ATB procurement cannot be identified in a public document.

TABLE C-2. QUANTITIES PROCURED UNDER "MODIFY THE TANKER RE-ENGINING PROGRAM"

	Fiscal Year					To
	1983	1984	1985	1986	1987	Complete
CBO Baseline						
CFM-56	25	58	64	72	72	N/A
Possible Administration a/						
CFM-56	25	58	64	72	72	N/A
Alternative						
JT3D b/	16	48	32	32	32	32

a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.

b. JT3D option based on earlier program proposed by the Air Force for 96 aircraft. The extension beyond 96 assumes availability of aircraft for purchase after FAA regulations prohibit operation of these aircraft in U.S. air space.

TABLE C-3. QUANTITIES PROCURED UNDER "MODIFY AND EXPAND NAVY BATTLE GROUP STRUCTURE"

	Fiscal Year					To
	1983	1984	1985	1986	1987	Complete
CBO Baseline						
CVN	0	1	0	0	0	N/A
Possible Administration a/						
CVN	2	0	0	0	0	1
Alternative						
CVN	0	0	0	0	0	0
Escorts/Airwings			b/			

a. Based on press reports of likely Administration actions.

b. Estimates of long-run costs under this option (which are presented in the text) assume that fewer escorts and airwings will be procured because there are three fewer aircraft carriers that require escorts. Specifically, estimates assume reductions in procurement of five CG-47s, seven DDGXs, and three airwings.

TABLE C-4. QUANTITIES PROCURED UNDER "RESTRUCTURE THE MODERNIZATION OF NAVAL AIR DEFENSES"

	Fiscal Year					To
	1983	1984	1985	1986	1987	Complete
CBO Baseline						
CG-47	2	4	4	4	4	N/A
Possible Administration a/						
CG-47	3	3	3	4	4	4 b/
Alternative						
CG-47	2	2	2	2	2	4
TER	0	0	0	0	0	81
SM-2	0	0	0	0	0	4,300
Backfit Kits	0	0	0	0	0	81

a. Based on press report in Shipyard Weekly, Shipbuilders Council of America, December 24, 1981.

b. Assumes fulfillment of current Navy objectives.

TABLE C-5. QUANTITIES PROCURED UNDER "PROCURE CONVENTIONAL SUBMARINES TO COMPLEMENT NUCLEAR ATTACK SUBMARINES"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
SSN-688	3	3	3	3	3	N/A
Possible Administration a/						
SSN-688	2	4	3	4	4	5
Alternative						
SSN-688	1	3	2	3	3	0
SSX	0	1	0	2	3	14

a. Based on press report in Shipyard Weekly, Shipbuilders Council of America, December 24, 1981.

TABLE C-6. QUANTITIES PROCURED UNDER "LIMIT M1 TANK PROCUREMENT AND SUPPLEMENT IT WITH M60s"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
M1	802	1,080	1,080	1,080	1,080	N/A
M60A1 upgrade	360	360	360	360	360	
Possible Administration a/						
M1	802	1,080	1,080	1,080	1,080	N/A
M60A1 upgrade	360	360	360	360	360	
Alternative						
M1	720	720	720	720	720	N/A
New M60A3	360	360	360	360	360	N/A
M60A1 upgrade	360	360	360	360	360	

a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.

TABLE C-7. QUANTITIES PROCURED UNDER "ALTER THE COMPOSITION OF THE INFANTRY FIGHTING VEHICLE PROGRAM"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
M2	711	792	986	1,100	1,044	N/A
Possible Administration a/						
M2	711	792	986	1,100	1,044	N/A
Alternative						
M2	360	360	600	600	600	N/A
M113 w/TOW	480	480	480	480	480	N/A
M113 w/Cannon	480	480	480	480	480	N/A

a. Lacking publicly available information, CBO assumed the possible Administration program matches the baseline program.

b. Based on informal contractor estimates, CBO assumed that each M113 equipped with TOW or 25-millimeter cannon costs $421,000 in constant 1983 dollars.

TABLE C-8. QUANTITIES PROCURED UNDER "REVISE THE NAVY AIRCRAFT MODERNIZATION PROGRAM"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
F-14	27	30	30	30	30	N/A
F/A-18	66	96	108	132	132	N/A
A-7X	0	0	0	0	0	N/A
Possible Administration a/						
F-14	27	30	30	30	30	82 b/
F/A-18	66	96	108	132	132	675 c/
A-7X	0	0	0	0	0	0
Alternative						
F-14	6 d/	0	0	0	0	0
F/A-18	66	96	108	108	108	126 e/
A-7X	0	0	0	25	58	782 f/

a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.

b. Assumes buy sufficient to fill out 26 squadrons and meet needs for pipeline and advanced attrition.

c. Based on total buy of 1,366.

d. Based on completing buy proposed by last Administration.

e. Based on buy of 1,366 less those for fight attack squadrons.

f. Based on buy of light attack aircraft. A-7X costs are from informal contractor estimates prepared in mid-1981.

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